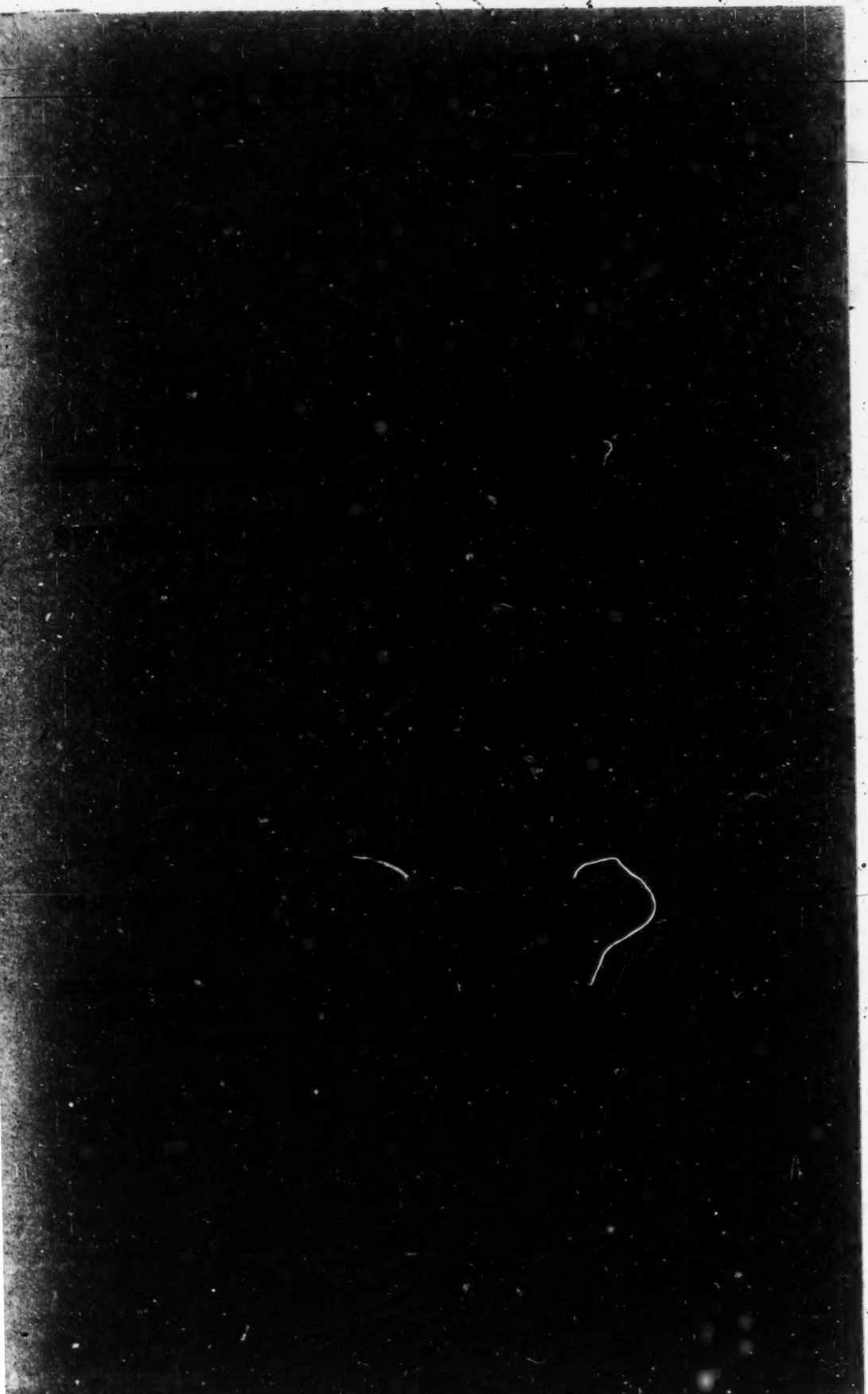

INDEX.

DOCKET No. 10050.

SOUTH TEXAS LUMBER COMPANY,
Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Appearances:
For Taxpayer: J. Arthur Platt.
For Comm'r: P. Louis Bergeron.

DOCKET ENTRIES.

1946.

Jan. 25—Petition received and filed. Taxpayer notified. Fee paid.

Jan. 25—Copy of petition served on General Counsel.

Jan. 25—Request for hearing at Houston, Texas, filed by taxpayer. 1/30/48 Granted.

Mar. 18—Answer filed by General Counsel.

Mar. 21—Hearing set May 13, 1946, Houston, Texas.

Mar. 22—Copy of answer served on taxpayer, Houston, Texas.

May 15—Hearing had before Judge Harland on merits. Stipulation of Facts filed at hearing. Petitioner's brief due 6/29/46. Respondent's Brief due 7/28/46. Reply brief due 8/12/46.

June 12—Transcript of hearing 5/13/46 filed.

June 13—Transcript of hearing 5/15/46 filed.

June 26—Brief filed by taxpayer. 6/27/46 Copy served.

July 29—Brief filed by General Counsel. Copy served 7/30/46.

Aug. 12—Reply brief filed by taxpayer 8/13/46. Copy served.

1946.

Aug. 30—Findings of Fact and Opinion rendered, Judge Harland. Judgment will be entered for the respondent. Copy served.

Sept. 9—Decision entered, Judge Harlan, Div. 11.

Oct. 7—Motion to vacate decision entered Sept. 9, 1946, filed by General Counsel.

Oct. 11—Order amending decision entered, Judge Harlan, Div. 11.

Dec. 2—Petition for review by U. S. Circuit Court of Appeals for the Fifth Circuit with assignments of error filed by taxpayer.

Dec. 5—Proof of service of petition for review filed.

Dec. 24—Agreed praecipe for record with proof of service thereon filed.

---

2 PETITION.

The Tax Court of the United States.

Received Jan. 25, 1946.

Filed Jan. 25, 1946.

South Texas Lumber Company, Petitioner,
vs. Docket No. 10050.
Commissioner of Internal Revenue, Respondent.

The above named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency, symbols "Dallas-IRA-90 D-H", dated November 5th, 1945,

signed by B. W. Wilde, Internal Revenue Agent in Charge, and as a basis for this proceeding alleges as follows:

I.

The petitioner is a corporation incorporated under the laws of the State of Texas, with principal office at Twentieth Floor Sterling Building (P. O. Box 1679), Houston, Texas. The Excess-Profits Tax return for the period here involved was timely filed with the Collector of Internal Revenue for the First District of Texas and on the accrual basis.

II.

The notice of deficiency, a copy of which is attached hereto and marked "Exhibit A", was mailed to the petitioner herein on November 5th, 1945.

III.

The taxes in controversy are Excess Profits Taxes for the calendar year 1943. The Commissioner asserted a deficiency of $6,797.84. Petitioner admits a deficiency of $5,089.31, leaving a net amount of $1,708.53 in controversy.

IV.

The determination of tax set forth in the said notice of deficiency is based upon the following errors:

(A) The Commissioner erred in failing and refusing to include in his computation of the invested capital account of petitioner for the calendar years 1941 and 1942, for the basis of the unused excess profits credit carried forward to the year 1943, so-called by Commissioner "unrealized

profits", on real estate sold on an installment payment plan as follows:

Unreported Profits on Installment Sales.	
At January 1, 1941	$10,984.03
At January 1, 1942	8,107.20

Commissioner computed the unused excess profits credit carry-over from 1941 and 1942 to the calendar year 1943 at $44,012.30, while petitioner, by reason of the inclusion of the above unreported profits on real estate installment sales in its invested capital, claims that said carry-over should be $45,539.59.

(B) The Commissioner erred in refusing to include in the invested capital of the petitioner for the year 1943 for excess profit tax computation $4,638.49, so-called by Commissioner "unrealized profits" on real estate sold on the installment plan.

V.

The facts upon which petitioner relies as the basis of this proceeding are as follows:

(A) Petitioner makes its income and excess profits tax returns on the accrual basis, and so made the same for the calendar years 1941, 1942 and 1943.

(B) Petitioner made sales of real estate in years prior to 1943 with payment on an installment plan, and reported for income tax purposes the profits made therefrom on the installment sales basis.

(C) In each instance the deferred payments on such installment sales were evidenced by the written obliga-

tions of the purchasers, being unconditional promises of the purchasers to pay the amounts shown therein.

(D) Petitioner, being on the accrual basis of accounting, carried on its books as receivables all of the said installment obligations it received from such sales.

(E) On December 31st of the years 1940, 1941 and 1942, there remained unreported for income tax purposes by petitioner of the total net profits realized by it from the sale of real estate on an installment basis prior to January 1st, 1943, the following amounts:

Year of Sale	Net Profit From Sale	Unreported Portion of Net Profit for Taxation		
		12-31-40	12-31-41	12-31-42
1937	24,797.58	8,541.39		
1938	5,867.26	2,442.64		
—				
1937	21,157.24		5,497.90	
1938	5,867.26		1,538.94	
1941	1,092.20		1,070.36	
—				
1937	12,012.82			3,361.56
1938	4,644.96			403.13
1941	1,092.20			873.80
		10,984.03	8,107.20	4,638.49

(F) Petitioner included in the computation of its invested capital for the year 1941 the above amount of $10,984.03, and in the year 1942 the above amount of $8,107.20 to arrive at the unused excess profits credit of $45,539.59 carried over from the years 1941 and 1942 to the year 1943. Commissioner failed or refused to include said amounts of $10,984.03 and $8,107.20 in his computation of

invested capital for the years 1941 and 1942 respectively, and thereby arrived at an amount of $44,012.30 as being unused excess profits carry-over to the calendar year 1943.

(G) Petitioner included the above amount of $4,638.49 in its invested capital account for excess profits tax purposes for the calendar year 1943. Commissioner refused to allow the inclusion of said amount in invested capital.

(H) Petitioner claims invested capital for the year 1943 is $1,658,252.96. Commissioner computes invested capital for the calendar year 1943 as $1,653,614.47.

(I) Petitioner claims that the total net profits from the said real estate sales shown above were realized profits in the years of sale and are includible in the invested capital of petitioner for the year beginning January 1st, next after date of sale, and further claims that by reason of being permitted by law to return said profits for income tax purposes on the installment basis does not preclude petitioner from including all of said profits in its invested capital as here claimed.

VI.

Wherefore, petitioner prays that the Court hear this proceeding and determine as follows:

(A) That the portion of the net profits on real estate installment sales, although unreported by petitioner for taxation in its income tax returns, should be included in the computation of the invested capital account of petitioner as follows:

For the calendar year 1941.....	$10,984.03
For the calendar year 1942.....	8,107.20
For the calendar year 1943.....	4,638.49

(B) That the unused excess profits credit carry-over from the years 1941 and 1942 to the calendar year 1943 should be computed on the basis of the inclusion of the amount of $10,984.03 in the invested capital account of petitioner for the calendar year 1941, and $8,107.20 in the invested capital account of petitioner for the calendar year 1942.

(C) That the additional excess profit taxes for the calendar year 1943 is $5,089.31.

SOUTH TEXAS LUMBER COMPANY,
Petitioner,
By T. H. MONROE, Vice-President.

20th Floor Sterling Building,
P. O. Box 1679,
Houston 1, Texas.

J. ARTHUR PLATT,
(J. Arthur Platt),
Counsel for Petitioner.

20th Floor Sterling Building,
Houston 1, Texas.

The State of Texas,
County of Harris.

T. H. Monroe, having been first duly sworn, says on oath that he is Vice President of South Texas Lumber Company, the petitioner above named; that he is duly authorized to verify the foregoing petition; that he has read the foregoing petition and is familiar with the statements therein contained; that he signed it in the capacity shown, and that the statements therein contained are true and correct.

T. H. MONROE,
(T. H. Monroe).

Subscribed and sworn to before me on this the 18th day of January, 1946.

BILLIE LENDERMON,
(Billie Lendermon),
Notary Public Harris County,
Texas.

(Seal)

My Commission Expires June 1, 1947.

8 EXHIBIT A.

Deficiency Letter.

Treasury Department.
Internal Revenue Service.
Dallas 1, Texas.

Office of
Internal Revenue Agent in Charge,
Dallas Division.

In Replying Refer to
Dallas.
IRA:90D-H.

November 5, 1945.

South Texas Lumber Company,
20th Floor Sterling Building,
Post Office Box 1679,
Houston, Texas.

Gentlemen:

You are advised that the determination of your income tax liability for the taxable year ended December 31, 1942, discloses a deficiency of $1,563.97 and an overassessment of $1,902.04 for the taxable year ended December 31, 1943; that

the determination of your declared value excess profits tax liability for the year ended December 31, 1943, discloses a deficiency of $252.68; that the determination of your excess profits tax liability for the taxable year ended December 31, 1943, discloses a deficiency of $6,797.84, as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency or deficiencies mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with The Tax Court of the United States, at its principal address, Washington 25, D. C., for a redetermination of the deficiency or deficiencies.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, 1200 Tower Petroleum Building, Dallas 1, Texas, for the attention of C:RLP. The signing and filing of this form will expedite the closing of your returns by permitting an early assessment of the deficiency or deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Very truly yours,
JOSEPH D. NUNAN, JR.,
Commissioner,
By (Sgd.) B. W. WILDE,
Internal Revenue Agent in Charge.

Enclosures:
Statement.
Form of waiver.
Form 843.

STATEMENT.

Dallas.
IRA:90D-H.

South Texas Lumber Company,
20th Floor Sterling Building,
Post Office Box 1679,
Houston, Texas.

Tax Liability for the Taxable Years Ended December 31, 1942, and 1943.

Income Tax.

Year	Liability	Assessed	Over-assessment	Deficiency
1942	$ 52,135.11	$ 50,571.14		$1,563.97
1943	75,366.19	77,268.23	$1,902.04	
Totals	$127,501.30	$127,839.37	$1,902.04	$1,563.97

Declared Value Excess Profits Tax

1943	$ 4,034.42	$ 3,781.74	.....	$ 252.68

Excess Profits Tax.

1943	$ 14,855.22	$ 8,057.38	.....	$6,797.84

In making this determination of your income, declared value excess-profits, and excess profits tax liability careful consideration has been given to the report of examination dated April 14, 1945.

The overassessment shown herein will be made the subject of a certificate of overassessment which will reach you in due course through the office of the collector of internal revenue for your district, and will be applied by that official in accordance with section 322 of the Internal Revenue Code, provided that you fully protect yourself against the running of the statute of limitations with respect to the apparent overassessment referred to in this letter, by filing with the collector of internal revenue for your district, (a) claim for refund on form 843, (a) copy of which is enclosed, the basis of which may be as set forth herein.

Taxable Year Ended December 31, 1942.

Adjustments to Net Income.

Net income for declared value excess profits tax computation as disclosed by return...		$131,756.53
Unallowable deductions and additional income:		
(a) Depreciation	$3,019.00	
(b) Real estate expense	900.00	
(c) Bad debt recoveries	283.40	
(d) Capital-stock tax	375.00	$ 4,577.40
Total		$136,333.93
Nontaxable income and additional deductions:		
(e) Capital gains		$ 1,068.02
Net income for declared value excess profits tax computation adjusted		$135,265.91

Explanation of Adjustments.

(a) Depreciation has been adjusted as shown by Exhibit "A" herewith.

(b) To eliminate deduction for commission paid on the Leland B. Jones sale $250.00, and on the McGregor Street property, $650.00. Such payments have been allowed as cost of sales.

(c) Of the total recoveries of $5452.86 in the taxable year the amount of $283.40 represented 1935 chargeoffs. Since you had a net profit in 1935 the recoveries are deemed to constitute taxable income when collected.

(d) Capital stock tax accrued in taxable year	$1,875.00
Capital stock tax deducted in your return	2,250.00
Capital stock tax deduction decreased	$ 375.00

(e) Capital gains have been reduced in amount of $1068.02 representing depreciation adjustments on the McGregor Street property which was sold in December, 1942, and adjustments to cost of sales for commissions paid on McGregor Street and Leland B. Jones properties. See adjusting item "(b)" above and Exhibit "B" herewith.

Computation of Income Tax.

Net income for declared value excess profits tax computation, as corrected	$135,265.91
Less: Dividends received credit	3,899.51
Normal and surtax net income	$131,366.40
Normal Tax:	
Tax at 24% on $131,366.40	$ 31,527.94
Surtax:	
Tax at 16% on $131,366.40	$ 21,018.62
Total normal and surtax	$ 52,546.56

Computation of Alternative Tax:

Normal and surtax net income	$131,366.40
Less: Net capital gain	2,743.04
Balance subject to normal and surtax	$128,623.36
Normal Tax:	
Tax at 24% on $128,623.36	$ 30,869.61
Surtax:	
Tax at 16% on $128,623.36	$ 20,579.74
Partial tax	$ 51,449.35
Tax at 25% on capital gain of $2,743.04	685.76
Alternative tax	$ 52,135.11
Total normal and surtax	$ 52,546.56
Correct income tax liability	$ 52,135.11
Income tax assessed, Account #21157	50,571.14
Deficiency of income tax	$ 1,563.97

Taxable Year Ended December 31, 1943.

Adjustments to Net Income.

Net income for declared value excess profits tax computation as disclosed by return		$211,296.72
Unallowable deductions and additional income:		
(a) Depreciation	$2,379.38	
(b) Capital gain	2,074.15	$ 4,453.53
Total		$215,750.25

Nontaxable income and additional deductions:	
(c) Capital stock tax	$ 625.00
Net income for declared value excess profits tax computation adjusted	$215,125.25

Explanation of Adjustments.

(a) See Exhibit "A" herewith.

(b) See Exhibit "B" herewith.

(c) Capital stock accrued in taxable year	$ 2,500.00
Capital stock tax deduction, per return	1,875.00
Capital stock tax deduction increased	$ 625.00

Alternative Tax Computation.

Normal and surtax net income	$190,587.43
Less: Capital gain (Exhibit "B" herewith)	5,791.88
Balance subject to normal and surtax	$184,795.55
Normal Tax:	
Tax at 24% on $184,795.55	$ 44,350.93
Surtax:	
Tax at 16% on $184,795.55	$ 29,567.29
Partial tax	$ 73,918.22
Tax at 25% on capital gain of $5,791.88	1,447.97
Alternative tax	$ 75,366.19

Computation of Tax.

Declared Value Excess Profits Tax:		
Net income for declared value excess profits tax computation as corrected		$215,125.25
Less:		
10% of $1,500,000.00 declared value capital stock for year ended June 30, 1943	$150,000.00	
85% of $4706.06 dividends received	3,997.60	$153,997.60
Balance subject to declared value excess profits tax		$ 61,127.65
Tax at 6.6% of $61,127.65		$ 4,034.42
Correct declared value excess profits tax liability		4,034.42
Declared value excess profits tax assessed, Acct. #411100		3,781.74
Deficiency of declared value excess profits tax		$ 252.68
Income Tax:		
Net income for declared value excess profits tax computation		$215,125.25
Less: Declared value excess profits tax		4,034.42
Net income		$211,090.83
Less:		
Income subject to excess profits tax	$16505.80	
Dividends received credit	3,997.60	20,503.40
Normal and surtax net income		$190,587.43

Normal Tax:

Tax at 24% on $190,587.43	$ 45,740.98
Surtax:	
Tax at 16% on $190,587.43	$ 30,493.99
Total normal and surtax	$ 76,234.97
Alternative tax	$ 75,366.19
Correct income tax liability	75,366.19
Income tax assessed, Account #411100	77,268.23
Overassessment of income tax	$ 1,902.04

Excess Profits Tax.

Adjustments to Excess Profits Net Income for the Taxable Year Computed Under Invested Capital Credit Method.

Excess profits net income as disclosed by return			$196,894.86
As corrected			197,807.26
Net adjustment as computed below			$ 912.40
Additions:			
(a) Net income adjustments	$3,828.53		
(b) Capital gains increased	$2,074.15		
(c) Bad debt recoveries	589.30		
(d) Declared value excess profits tax	252.68	2,916.13	$ 912.40

Explanation of Items.

(a) Individual adjustments explained hereinabove following adjustments to net income schedule, year 1943.

(b) To adjust excess profits net income for increase in gain on sale of capital assets. See adjusting item "(b)" Adjustments to Net Income schedule, above.

(c) See Exhibit "C" herewith.

(d) To adjust for deficiency of declared value excess profits tax as shown by Computation of Tax schedule, year 1943, hereinabove.

Excess Profits Credit—Based on Invested Capital.

	Invested Capital		
	Per Return	Adustment	As Corrected
Equity invested capital at beginning of taxable year	$1,713,232.48	(a) (4,006.48)	1,709,226.00
Average equity invested capital ...	1,713,232.48	(4,006.48)	1,709,226.00
Reduction on account of inadmissible assets	55,611.53		55,611.53
Invested capital	$1,657,620.95	$(4,006.48)	$1,653,614.47

Excess Profits Credit.

Excess profits credit, 8% of $1,653,614.47 invested capital	$132,289.16

Explanation of Items.

(a) Amount of accumulated earnings and profits, per return			$313,232.48
Amount of accumulated earnings and profits, as corrected			309,226.00
Net adjustment, as computed below			$ 4,006.48
Additions:			
(1) Net income adjustments 1942		$2,325.98	
Deductions:			
(2) Unrealized profits	$4,638.49		
(3) Cost depletion	130.00		
(4) Additional 1942 income tax	1,563.97	6,332.46	
Net adjustments as shown above		$4,006.48	

Explanation of Adjustments.

(1) Total 1942 adjustments (Adjustments to Net Income schedule, year 1942, hereinabove)			$ 3,509.38
Less:			
Real estate expense transferred to capital gain and unrealized profits	$900.00		
Bad debt recoveries already in surplus	283.40	$ 1,183.40	
Net adjustment affecting surplus			$ 2,325.98
(2) To exclude unrealized profits from installment sales			$4,638.49

(3) To adjust surplus for depletion to the extent of cost for the English Stuart 12 acre lease and the Burt 46 acre lease.

(4) To adjust surplus for amount of income tax deficiency for taxable year 1942.

Taxable Year Ended December 31, 1943.

Excess Profits Tax Computation.

Excess profits net income, as adjusted			$197,807.26
Less:			
Specific exemption		$ 5,000.00	
Excess profits credit		132,289.16	
Unused excess profits credit, (Exhibit "D" herewith)		44,012.30	181,301.46
Adjusted excess profits net income			$ 16,505.80
90 percent of $16,505.80			14,855.22 (1)
Surtax net income (computed without regard to the credit provided by section 26(e))			207,093.23
80 percent of $207,093.23			165,674.58 (2)
Income tax			75,366.19 (3)
Excess of item 2 over item 3			90,308.39 (4)
Item 1 or item 4, whichever is lesser			14,855.22
Excess profits tax			14,855.22
Excess profits tax due			14,855.22

Post War Refund of Excess Profits Tax and Credit for Debt Retirement.

Excess profits tax, imposed	$14,855.22

Credit allowable under sections 780 and 781..	1,485.52
Net reduction in indebtedness under section 783 .....None	
Credit for debt retirement under section 783..	None
Net post war refund	$ 1,485.52
Correct excess profits tax liability	$14,855.22
Excess profits tax assessed:	
Original account #400402	$ 8,057.38
Deficiency in excess profits tax	$ 6,797.84

EXHIBIT C.

Bad Debt Recovery Adjustments Year ended 12/31/1943.

1941:	
Total bad debts recoveries	$5,384.99
Less: Recoveries of chargeoffs resulting in No Tax saving	1,485.80
Net bad debt recoveries reported as income	$3,899.19
Less: Recoveries of bad debts charged off subsequent to 1/1/1940	493.64
Bad debt recovery adjustment for Excess Profits Net Income in computation of Excess Profits Credit Carryover	$3,405.55
1942:	
Total bad debt recoveries	$5,452.86
Less: Recoveries of chargeoffs resulting in No Tax Saving	811.45

Net bad debt recoveries included in income	$4,641.41
Less: Recoveries of bad debts charged off subsequent to 1/1/40	1,738.85
Bad debt recovery adjustment for excess profits net income in computation of excess profits credit carryover	$2,902.56

1943:

Total bad debt recoveries	$9,707.84
Less: Recoveries of chargeoffs resulting in no tax saving	3,640.99
Net bad debt recoveries reported as income.	$6,066.85
Less: Recoveries of bad debts charged off subsequent to 1/1/40	3,278.22
Corrected bad debt recovery adjustment for excess profits net income	$2,788.63
Per return	2,199.33
Net adjustment	$ 589.30

EXHIBIT "D".

Excess Profits Credit Carry-Over Computation.

Year Ended 12/31/1943.

Invested Capital Method.

1941:

Money paid in for stock	$ 50,000.00
Stock dividends	1,350,000.00
Total capital	$1,400,000.00

Accumulated earning and profits per books—1/1/1941		$313,152.09	
Less: Cost depletion Burt Lease not on books		30.00	313,122.09
Average invested capital			$1,713,122.09
Less: Reduction on account of inadmissibles, per return			56,982.70
Invested Capital			$1,656,139.39
Excess profits credit based on Invested Capital, 8% of above			$132,491.15
1942:			
Total capital as above			$1,400,000.00
Accumulated earnings per books—1/1/42		$311,936.37	
Less: Cost depletion not on books:			
Burt Lease	$ 30.00		
English Stuart Lease	100.00	130.00	311,806.37
Average invested capital			$1,711,806.37
Less: Reduction on account of inadmissibiles, per return			56,606.63
Invested Capital			$1,655,199.74
Excess profits credit based on invested capital, 8% of above			$132,415.98
1941—Credit		$132,491.15	
Net income as corrected $109,075.60			
Less:			
Dividends	$5,838.84		
Capital gains	3,969.03		
Bad debts	3,405.55	13,213.42	95,862.18
1941 Excess profits credit carry-over			$36,628.97

1942—Credit			$132,415.98
Net income adjusted—			
Sched. 1		$135,265.91	
Less:			
Dividends	$4,587.66		
Capital gains	2,743.04		
Bad debt	2,902.56	10,233.26	125,032.65
1942 excess profits credit carry-over			$ 7,383.33
Net excess profits credit carry-over to 1943..			$44,012.30

21

ANSWER.

Received Mar. 18, 1946.

Filed Mar. 18, 1946.

(Title Omitted.)

Comes now the Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed in this appeal, admits and denies as follows:

I-III.

Admits the allegations contained in paragraphs I, II, and III of the petition.

IV.

(A)-(B). Denies that the Commissioner erred in the manner alleged in subparagraphs (A) and (B) of paragraph IV of the petition.

V.

(A)-(B). Admits the allegations of fact contained in subparagraphs (A) and (B) of paragraph V of the petition.

(C)-(D). Denies the allegations of fact contained in subparagraphs (C) and (D) of paragraph V of the petition.

(E). Admits the allegations of fact contained in subparagraph E of paragraph V of the Petition.

(F)-(G). Denies the allegations of fact contained in subparagraphs (F) and (G) of paragraph V of the petition.

(H). Admits that the Commissioner computes invested capital for the calendar year 1943 as $1,653,614.47, but denies the remaining allegations of fact contained in subparagraph (H) of paragraph V of the petition.

(I). Denies the allegations of fact contained in subparagraph (I) of paragraph V of the petition.

Denies generally and specifically each and every allegation contained in the petition not hereinbefore expressly admitted, qualified, or denied.

Wherefore, it is prayed that the determination of the Commissioner be approved.

(Signed) J. P. WENCHEL, FBS.
(J. P. Wenchel),
Chief Counsel, Bureau of
Internal Revenue.

Of Counsel:
JAMES L. BACKSTROM,
Division Counsel,
DONALD ABBEY,
Special Attorney,
Bureau of Internal Revenue.

DA:tew 3-12-46.

---

23 STIPULATION OF FACTS.

Filed May 15, 1946.

(Title Omitted.)

It is hereby stipulated and agreed that the following facts are true and correct, without prejudice to the right of either party to offer additional evidence not inconsistent or contrary to the facts herein set out.

1. South Texas Lumber Company, hereinafter referred to as petitioner, is a corporation organized on September 17, 1902, under the laws of the State of Texas, with its principal place of business as a retail dealer in lumber and building material located in Houston, within the First Collection District of Texas.

2. Petitioner keeps its books and files its income and excess profits tax returns on the calendar year and accrual basis.

3. During the course of its business life petitioner acquired title to certain real estate situated in the State of Texas. Beginning with the taxable year 1937, petitioner has made sales of portions of such real estate and, in accordance with section 44(b) of the Internal Revenue Code, has elected to compute and report the profit thereon on the installment basis. In each of the transactions where petitioner made such real estate installment sales, deeds were given to purchasers, and the deferred payments were evidenced by promissory notes executed by the purchaser, payable to the order of petitioner as therein shown, and were secured by vendor's lien and mortgage lien against the land. Petitioner, being on the accrual basis of accounting, carried on its books as receivables all of the said installment obligations so received by it from such sales.

4. The books disclose the following with reference to such sales:

Name—1937	Cost	Sales Price	Profit	Per Cent	Reported Profits 1937-1940	Unreported Profits 12-31-40
Melton	0	$ 1,500.00	$ 1,500.00	100.00	$ 877.31	$ 622.69
Crowley	$ 1,891.69	3,750.00	1,858.31	49.555	600.19	1,258.12
Freitag	806.87	2,552.40	1,745.53	68.39	1,186.84	558.69
Lacas	610.50	1,931.20	1,320.70	68.39	898.08	422.62
Porter	796.63	3,170.00	2,373.37	74.87	1,749.96	623.41
Arls	826.97	4,443.00	3,616.03	81.39	2,151.07	1,464.96
Towson	2,149.64	8,250.00	6,100.36	73.94	3,882.00	2,218.36
Winn	1,019.18	3,224.00	2,204.82	68.39	1,119.05	1,085.77
Rosen	3,561.88	4,000.00	438.12	10.95	151.35	286.77
1938						
Speed	477.72	1,700.02	1,222.30	71.90	928.95	293.35
Modglin	3,034.80	7,679.76	4,644.96	60.48	2,495.67	2,149.29
1941						
Jones	3,907.80	5,000.00	1,092.20	21.84	0	0
Totals	$19,083.68	$47,200.38	$28,116.70		$16,040.47	$10,984.03

5. At the time provided by law petitioner filed corporation income tax (Form 1120) and corporation excess profits tax (Form 1121) returns for the calendar years 1941, 1942 and 1943, disclosing net income and income taxes due thereon for the three years and excess profits tax for the calendar year 1943. In arriving at the net income for the said three years, petitioner reported the following realized profits on the installment sales previously referred to above:

	1941	1942	1943
1937 Sales	$3,043.49	$2,136.34	$2,396.87
1938 Sales	903.70	1,135.81	403.13
1941 Sales	21.84	196.56	190.98
Totals	$3,969.03	$3,468.71	$2,990.98

6. The balance sheets attached to and made a part of the income tax returns disclosed the following unreported income from installment sales classified as "Unrealized Profit Installment Sales":

	12-31-40	12-31-41	12-31-42	12-31-43
1937	$ 8,541.39	$5,497.90	$3,361.56	$ 964.69
1938	2,442.64	1,538.94	403.13	0
1941	0	1,070.36	873.80	682.82
Totals	$10,984.03	$8,107.20	$4,638.49	$1,647.51

7. In its corporation excess profits tax return, Form 1121, for the calendar year 1943, petitioner claimed the unreported income from installment sales, $4,638.49, as a part of surplus and undivided profits in arriving at its equity invested capital. It also claimed the unreported income from installment sales, $10,984.03, as at December 31, 1940, and $8,107.20 as at December 31, 1941, in arriving at its

equity invested capital for the calendar years 1941 and 1942, respectively, for the purpose of its unused excess profits credit carry-over from the calendar years 1941 and 1942 to the calendar year 1943.

8. The capital stock, surplus and undivided profits and reserve for depletion, as disclosed by the balance sheets as at December 31, 1940, December 31, 1941, December 31, 1942, and December 31, 1943, attached and made a part of petitioner's corporation income tax returns, Form 1120, for said years, were as follows:

Year Ended	Capital Stock	Net Surplus	Reserve for Depletion
December 31, 1940	$1,400,000.00	$313,152.09	.....
December 31, 1941	1,400,000.00	311,936.37	.....
December 31, 1942	1,400,000.00	307,344.13	$1,249.86
December 31, 1943	1,400,000.00	320,822.22	2,828.50

Included in the capital stock of $1,400,000.00 was the original stock issued, $50,000.00, and $1,350,000.00 stock dividends subsequently issued.

9. The tax in controversy in this case is the excess profits tax for the calendar year 1943. The Commissioner, as disclosed by the statutory notice of deficiency dated November 5, 1945 (Ex. A of the petition), reduced petitioner's equity invested capital for the calendar years 1941, 1942 and 1943 by the amounts of unreported profits from installment sales previously referred to in paragraphs 6 and 7 above in the respective amounts of $10,984.03, $8,107.20 and $4,638.49.

J. ARTHUR PLATT,
Counsel for Petitioner.

J. P. WENCHEL, JLB.
(J. P. Wenchel),
Chief Counsel, Bureau of Internal Revenue.

7 T. C. No. 81.

The Tax Court of the United States.

South Texas Lumber Company, Petitioner,
vs.
Commissioner of Internal Revenue, Respondent.

Docket No. 10050. Promulgated August 30, 1946.

Petitioner, a corporation which kept its books and filed its income and excess profits tax returns on the accrual basis, elected to compute and report the profit on installment sales of real estate made by it on the installment basis in accordance with section 44(b), I. R. C. *Held*, petitioner's anticipated and unreported income from installment sales as of the beginning of the years 1941, 1942 and 1943 is not includible as part of its "accumulated earnings and profits" in arriving at its equity invested capital within the meaning of section 718 (a) (4), I. R. C.

J. Arthur Platt, Esq., for the petitioner.
P. Louis Bergeron, Esq., for the respondent.

Petitioner seeks a redetermination of a deficiency in excess profits tax for the year 1943 in the original amount of $6,797.34, which amount, however, has since been reduced by negotiations between the parties leaving a net amount in controversy of $1,708.53.

The question involved is whether petitioner is entitled to include the anticipated and unreported profits from installment transactions outstanding on its books as at January 1, 1941, 1942 and 1943 as part of its surplus or "accumulated earnings and profits" in arriving at its equity

invested capital within the meaning of section 718 (a) (4), I. R. C.

FINDINGS OF FACT.

This case was submitted on the following agreed statement of facts:

1. South Texas Lumber Company, hereinafter referred to as petitioner, is a corporation organized on September 17, 1902, under the laws of the State of Texas, with its principal place of business as a retail dealer in lumber and building material located in Houston, within the First Collection District of Texas.

2. Petitioner keeps its books and files its income and excess profits tax returns on the calendar year and accrual basis.

3. During the course of its business life petitioner acquired title to certain real estate situated in the State of Texas. Beginning with the taxable year 1937, petitioner has made sales of portions of such real estate and, in accordance with section 44(b) of the Internal Revenue Code, has elected to compute and report the profit thereon on the installment basis. In each of the transactions where petitioner made such real estate installment sales, deeds were given to purchasers, and the deferred payments were evidenced by promissory notes executed by the purchaser, payable to the order of petitioner as therein shown, and were secured by vendor's lien and mortgage lien against the land. Petitioner, being on the accrual basis of accounting, carried on its books as receivables all of the said installment obligations so received by it from such sales.

4. The books disclose the following with reference to such sales:

Name—1937	Cost	Sales Price	Profit	Per Cent	Reported Profits 1937-1940	Unreported Profits 12-31-40
Melton	0	$ 1,500.00	$ 1,500.00	100.00	$ 877.31	$ 622.69
Crowley	$ 1,891.69	3,750.00	1,858.31	49.555	600.19	1,258.12
Freitag	806.87	2,552.40	1,745.53	68.39	1,186.84	558.69
Lacas	610.50	1,931.20	1,320.70	68.39	898.08	422.62
Porter	796.63	3,170.00	2,373.37	74.87	1,749.96	623.41
Arls	826.97	4,443.00	3,616.03	81.39	2,151.07	1,464.96
Towson	2,149.64	8,250.00	6,100.36	73.94	3,882.00	2,218.36
Winn	1,019.18	3,224.00	2,204.82	68.39	1,119.05	1,085.77
Rosen	3,561.88	4,000.00	438.12	10.95	151.35	286.77
1938						
Speed	477.72	1,700.02	1,222.30	71.90	928.95	293.35
Modglin	3,034.80	7,679.76	4,644.96	60.48	2,495.67	2,149.29
1941						
Jones	3,907.80	5,000.00	1,092.20	21.84	0	0
Totals	$19,083.68	$47,200.38	$28,116.70		$16,040.47	$10,984.03

5. At the time provided by law petitioner filed corporation income tax (Form 1120) and corporation excess profits tax (Form 1121) returns for the calendar years 1941, 1942 and 1943, disclosing net income and income taxes due thereon for the three years and excess profits tax for the calendar year 1943. In arriving at the net income for the said three years, petitioner reported the following realized profits on the installment sales previously referred to above:

	1941	1942	1943
1937 Sales	$3,043.49	$2,136.34	$2,396.87
1938 Sales	903.70	1,135.81	403.13
1941 Sales	21.84	196.56	190.98
Totals	$3,969.03	$3,468.71	$2,990.98

6. The balance sheets attached to and made a part of the income tax returns disclosed the following unreported income from installment sales classified as "Unrealized Profit Installment Sales":

	12-31-40	12-31-41	12-31-42	12-31-43
1937	$ 8,541.39	$5,497.90	$3,361.56	$ 964.69
1938	2,442.64	1,538.94	403.13	0
1941	0	1,070.36	873.80	682.82
Totals	$10,984.03	$8,107.20	$4,638.49	$1,647.51

7. In its corporation excess profits tax return, Form 1121, for the calendar year 1943, petitioner claimed the unreported income from installment sales, $4,638.49, as a part of surplus and undivided profits in arriving at its equity invested capital. It also claimed the unreported income from installment sales, $10,984.03, as at December 31, 1940, and $8,107.20 as at December 31, 1941, in arriving at its

equity invested capital for the calendar years 1941 and 1942, respectively, for the purpose of its unused excess profits credit carry-over from the calendar years 1941 and 1942 to the calendar year 1943.

8. The capital stock, surplus and undivided profits and reserve for depletion, as disclosed by the balance sheets as at December 31, 1940, December 31, 1941, December 31, 1942, and December 31, 1943, attached and made a part of petitioner's corporation income tax returns, Form 1120, for said years, were as follows:

Year Ended	Capital Stock	Net Surplus	Reserve for Depletion
December 31, 1940	$1,400,000.00	$313,152.09	.....
December 31, 1941	1,400,000.00	311,936.37	.....
December 31, 1942	1,400,000.00	307,344.13	$1,249.86
December 31, 1943	1,400,000.00	320,822.22	2,828.50

Included in the capital stock of $1,400,000.00 was the original stock issued, $50,000.00, and $1,350,000.00 stock dividends subsequently issued.

9. The tax in controversy in this case is the excess profits tax for the calendar year 1943. The Commissioner, as disclosed by the statutory notice of deficiency dated November 5, 1945, reduced petitioner's equity invested capital for the calendar years 1941, 1942 and 1943 by the amounts of unreported profits from installment sales previously referred to in paragraphs 6 and 7 above in the respective amounts of $10,984.03, $8,107.20 and $4,638.49.

OPINION.

HARLAND, *Judge:* Since the hearing of this case and since the filing of petitioner's brief a case, undistinguishable on its relevant facts from the case at bar, has been decided by this Court. On July 11, 1946, this Court decided in *Kimbrell's Home Furnishings, Inc.*, 7 T. C. No. 40, that a corporation engaged in the sale of furniture at re-

tail on the installment basis could not, in the computation of its equity invested capital, include unrealized profits as represented by unpaid installment notes received from the purchasers at the time of the sale. All of the questions raised by both the petitioner and the respondent herein are fully discussed in the decision in the *Kimbrell's Home Furnishings, Inc.*, case, *supra*.

Petitioner, in his reply brief, seeks to distinguish the *Kimbrell* case from the one at bar due to the fact that in the former case the taxpayer computed its net income on the installment basis as provided by section 44 (a) and its excess profits net income on the accrual basis; whereas in the case at bar the taxpayer filed its income and excess profits tax returns on the accrual basis but "elected to compute and report the profit" from its installment sales under section 44 (a).

The claimed distinction impresses us as being without substance. In both cases the taxpayers included anticipated and unreported profits from installment sales in equity invested capital as "accumulated earnings and profits".[1]

Approval of this treatment of anticipated and unreported profits from installment sales would be equivalent to an admission that a different rule applies in the computation of accumulated earnings and profits for excess profits purposes than in the computation of earnings and profits for income tax purposes. In *Federal Union Insurance Co.*, 5 T. C. 374, we held to the contrary.

Judgment will be entered for the respondent

(Seal)

---

[1] SEC. 718 [I. R. C.] EQUITY INVESTED CAPITAL.

(a) Definition.—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts reduced as provided in subsection (b)—

* * * * *

(4) Earnings and Profits at Beginning of Year.—The accumulated earnings and profits as of the beginning of such taxable year; * * *

32 DECISION.

The Tax Court of the United States,
Washington.

South Texas Lumber Company, Petitioner,
vs. Docket No. 10050.
Commissioner of Internal Revenue, Respondent.

Pursuant to the determination of the Court, as set forth in its Findings of Fact and Opinion, promulgated August 30, 1946, it is

Ordered and Decided: That there is a deficiency in excess profits tax of $1,708.53 for the year 1943.

Enter: Entered Sept. 9, 1946.
(S.) BYRON B. HARLAN,
(Seal) Judge.

MOTION TO VACATE DECISION ENTERED SEPTEMBER 9, 1946.

Received Oct. 7, 1946.

Filed Oct. 7, 1946.

(Title Omitted.)

Now comes the respondent by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and moves that the decision in this case be corrected and as reasons therefor respectfully alleges as follows:

1. By statutory notice dated November 9, 1945, the respondent notified petitioner that it was liable for a deficiency in excess profits tax in the amount of $6,797.84.

2. Petitioner did not, at any time, file a consent waiving assessment, Form 870, as to any part of said deficiency.

3. On January 25, 1946, petitioner filed a petition with this Court in which it alleged a deficiency of $6,797.84, in which it admitted a liability of $5,089.31, leaving a net deficiency of $1,708.53 in controversy. At no time prior or subsequent thereto did the petitioner attempt to sign or file a Consent to Immediate Assessment (Form 870) as to the $5,089.31, nor was any of the said $5,089.31 assessed pending the outcome of this proceeding.

Wherefore, it is prayed that this motion be granted and the deficiency in excess profits tax for the calendar year 1943 as shown in the decision entered September 9, 1946, be vacated and a new decision entered for the full amount of the deficiency of $6,797.84 in lieu thereof.

(Signed) J. P. WENCHEL, JLB.
(J. P. Wenchel),
Chief Counsel, Bureau of
Internal Revenue.

Of Counsel:
JAMES L. BACKSTROM,
Division Counsel,
D. LOUIS BERGERON,
Special Attorney,
Bureau of Internal Revenue.

DLB:jr. 10-2-46.

35 ORDER.

The Tax Court of the United States,
Washington.

South Texas Lumber Company, Petitioner,
vs. Docket No. 10050.
Commissioner of Internal Revenue, Respondent.

On motion of respondent it is

Ordered that the decision entered herein September 9, 1946, be and the same is hereby amended to show the amount of the deficiency in excess profits tax to be $6,797.84, instead of $1,708.53 as shown in the original decision.

In all other respects the decision shall stand as originally entered.

(Signed) BYRON B. HARLAN,
(Seal) Judge.

Dated: Washington, D. C., October 11, 1946.

PETITION FOR REVIEW AND ASSIGNMENTS OF ERROR.

36 Received Dec. 2, 1946.

Filed Dec. 2, 1946.

Filed November 1946.

In the United States Circuit Court of Appeals for the Fifth Circuit.

South Texas Lumber Company, Petitioner,
vs.
Joseph D. Nunan, Jr., Commissioner of Internal Revenue, Respondent.

C. C. A. No. ..... T. C. No. 10050

To the Honorable Judges of the United States Circuit Court of Appeals for the Fifth Circuit:

Now comes South Texas Lumber Company, a corporation, by and through its attorney, J. Arthur Platt, and files this, its petition for review by the United States Circuit Court of Appeals for the Fifth Circuit of the decision of The Tax Court of the United States entered September 9, 1946, and amended by an order of the Court dated October 11, 1946, and respectfully shows:

I.

Jurisdiction.

The petitioner is a corporation organized and existing under the laws of the State of Texas, with its domicile and principal place of business in the City of Houston,

Harris County, Texas. The respondent is the duly appointed, qualified and acting Commissioner of Internal Revenue of the United States, holding his office by virtue of the laws of the United States. The petitioner, at the time provided by law, filed its federal excess profits tax return for the calendar year 1943, the taxable year here involved, with the Collector of Internal Revenue for the First District of Texas, whose office is located in Austin, Texas, and is within the jurisdictional limits of the United States Circuit Court of Appeals for the Fifth Circuit. The petitioner files this petition pursuant to the provisions of Section 1141 and 1142 of the U. S. Internal Revenue Code.

II.

Prior Proceedings.

On November 5, 1945 (Exhibit A of Petition), the respondent determined a deficiency in federal excess profits tax liability against the petitioner in the amount of $6797.84 for the taxable year 1943, and forwarded to the petitioner by registered mail a notice of said deficiency, in accordance with the provisions of existing Internal Revenue laws. Thereafter, and within the time prescribed by law, petitioner filed an appeal from the said determination with The Tax Court of the United States. The petitioner admitted certain items of assessment, leaving a net amount of $1708.53 remaining in controversy in this cause. On August 30, 1946, The Tax Court entered its findings of fact and opinion (7 T. C. No. 81). Pursuant to said opinion, The Tax Court entered a decision in this cause on September 9, 1946, wherein and whereby it was ordered and decided that there is a deficiency in petitioner's excess profits tax for the calendar year 1943 in the amount of $1708.53. Thereafter The Tax Court made and entered its final order in this cause, dated October 11, 1946, whereby

the Court's decision dated September 9, 1946, was amended so as to show the deficiency in petitioner's excess profits tax for the year 1943 in the amount of $6797.84 instead of $1708.53, as shown in the original decision.

III.

Nature of Controversy.

Petitioner is seeking a redetermination of a deficiency assessment in excess profits taxes for the calendar year 1943 made against it by respondent in the amount of $6797.84. Prior to the trial in The Tax Court petitioner admitted certain items of the assessment as being correct, leaving a net amount of $1708.53 remaining in controversy. The question involved is whether petitioner is entitled to include the profits, unreported for income taxes, derived by it from real estate installment sales, outstanding on its books as at January 1, 1941, 1942 and 1943, as part of its "accumulated earnings and profits" in determining its equity invested capital within the meaning of section 718(a)(4), Internal Revenue Code.

Petitioner is a Texas corporation organized in the year 1902, with its principal place of business as a dealer in lumber and building materials located in Houston within the First Collection District of Texas. Petitioner keeps its books and files its income and excess profits tax returns on the calendar and accrual basis. In the course of its business petitioner acquired title to certain real estate situated in the State of Texas. Beginning with the taxable year 1937, petitioner made sales of portions of such real estate, and as authorized and permitted by Section 44(b) of the Internal Revenue Code, elected to compute, and report the profit thereon on the installment sales basis. In each of the transactions where petitioner made

such real estate installment sales, deeds were given to purchasers, and the deferred payments were evidenced by promissory notes executed by the purchasers, payable to the order of petitioner as therein shown, and were secured by vendor's lien and mortgage lien against the land. Petitioner, being on the accrual basis of accounting, carried on its books as receivables all of the said installment obligations so received by it from such sales.

At the time provided by law petitioner filed corporation income tax (form 1120) and corporatin exeess profits tax from 1121) returns for the calendar years 1941, 1942 and 1943, disclosing net income and income taxes due thereon for the three years and excess profits tax for the calendar year 1943. In arriving at the net income for said three years, petitioner reported the following realized profits on the real estate installment sales referred to above:

	1941	1942	1943
1937 Sales	$3,043.49	$2,136.34	$2,396.87
1938 Sales	903.70	1,135.81	403.13
1941 Sales	21.84	196.56	190.98
Totals	$3,969.03	$3,468.71	$2,990.98

The balance sheets attached to and made a part of the income tax returns disclosed the unreported income from said real estate installment sales as follows:

	12-31-40	12-31-41	12-31-42	12-31-43
1937	$ 8,541.39	$5,497.90	$3,361.56	$ 964.69
1938	2,442.64	1,538.94	403.13	0
1941	0	1,070.36	873.80	682.82
Totals	$10,984.03	$8,107.20	$4,638.49	$1,647.51

In its corporation excess profits tax return, Form 1121, for the calendar year 1943, petitioner claimed the unreported income from such real estate installment sales, amounting to $4638.49, as a part of its surplus and undivided profits in arriving at its equity invested capital. It also claimed the unreported income from said installment sales, $10,984.03 as at December 31, 1940, and $8,107.20 as at December 31, 1941, in arriving at its equity invested capital for the calendar years 1941 and 1942, respectively, for the purpose of its unused excess profits credit carry-over from the calendar years 1941 and 1942 to the calendar year 1943. Respondent reduced petitioner's equity invested capital account for the calendar years 1941, 1942 and 1943 by the above mentioned amounts, thereby excluding from petitioner's equity invested capital account for the calendar years 1941, 1942 and 1943 the amounts of profits derived by it from installment sales of real estate made prior to the year 1943 on which petitioner elected to defer payment of income tax in accordance with Section 44(b) of the Internal Revenue Code. The Tax Court sustained the determination of the respondent.

IV.

Designation of Court of Review.

The petitioner being aggrieved by the opinion and decision of The Tax Court of the United States in its proceeding hereby petitions for a review of said opinion and decision by the United States Circuit of Appeals for the Fifth Circuit, and for the correction of manifest errors which occur therein to its prejudice.

V.

Assignments of Error.

1. The Tax Court erred in finding and holding that petitioner was not entitled to include the anticipated and

unreported profits, obtained from real estate installment sales made by it and outstanding on its books as at January 1, 1941, 1942 and 1943, as part of its surp' :s or "accumulated earnings and profits" in arriving at its equity invested capital within the meaning of Section 718(a), Internal Revenue Code.

2. The Tax Court erred in sustaining the action of respondent in excluding from Petitioner's equity invested capital account for the calendar years 1941, 1942 and 1943 the amounts of profits derived by it from real estate installment sales, made by it prior to the year 1943, on which petitioner elected to defer payment of income taxes in accordance with Section 44(b) of the Internal Revenue Code, it being admitted that petitioner regularly keeps its books and files its income and excess profits tax returns on the calendar year and accrual basis of accounting.

3. The Tax Court erred in finding and deciding that there is a deficiency of $6797.84 in petitioner's excess profits tax liability for the calendar year 1943.

Wherefore, Petitioner prays that the opinion and decision of The Tax Court of the United States be reviewed by the United States Circuit Court of Appeals for the Fifth Circuit, that a transcript of the record be prepared in accordance with the law and rules of said Court and be transmitted to the Clerk of said Court for filing; that the opinion and decision of The Tax Court be reversed, vacated and set aside, and the cause remanded, and that petitioner be granted such other and further relief to which it may be entitled herein.

J. ARTHUR PLATT,
Attorney for Petition.

20th Floor Sterling Building,
Houston 1, Texas.

The State of Texas,
County of Harris.

J. Arthur Platt, being duly sworn, deposes and says on his oath as follows:

I am an attorney at law, and am the attorney in the foregoing matter for Petitioner on Review, and as such I am duly authorized to verify the annexed and foregoing Petition for Review; I prepared the annexed and foregoing petition and am familiar with the contents thereof and believe the allegations contained in said petition to be true, and said petition is true according to the best of my knowledge, information and belief. Said petition is not filed for the purpose of delay, and I believe the petitioner is justly entitled to the relief sought.

J. ARTHUR PLATT,
(J. Arthur Platt).

Subscribed and sworn to before me by J. Arthur Platt on this the 27th day of November, 1946.

MYRA HEMPHILL,
(Seal) (Myra Hemphill),
Notary Public, Harris County, Texas.

My Commission Expires June 1, 1947.

NOTICE OF FILING PETITION FOR REVIEW AND ACCEPTANCE OF SERVICE THEREOF.

43 Filed Dec. 5, 1946.

Filed December .. 1946.

In the United States Circuit Court of Appeals for the Fifth Circuit.

South Texas Lumber Company, Petitioner,

vs.

Joseph D. Nunan, Jr., Commissioner of Internal Revenue, Respondent.

C. C. A. No. ..... T. C. No. 10050

The Honorable J. P. Wenchel, Chief Counsel,
Bureau of Internal Revenue,
Washington, D. C.

You are hereby notified that South Texas Lumber Company has filed with The Tax Court of the United States at Washington, D. C., a Petition for Review by the United States Circuit Court of Appeals for the Fifth Circuit of the decision of The Tax Court of the United States heretofore rendered in the above entitled cause. A copy of the Petition for Review and Assignments of Error, as filed, is hereto attached and served on you.

Dated this the 2nd day of December, 1946.

(S.) J. ARTHUR PLATT,
(J. Arthur Platt),
Attorney for Petitioner on Review.

Personal service of the annexed and foregoing notice, together with a copy of the Petition for Review and Assignments of Error mentioned therein, is hereby acknowledged on this the 4th day of December, 1946.

(S.) J. P. WENCHEL, SLY.
(J. P. Wenchel),
Chief Counsel, Bureau of Internal Revenue, Washington, D. C., Attorney for Respondent.

---

45 PRAECIPE FOR RECORD.

Received Dec. 24, 1946.

Filed Dec. 24, 1946.

(Title Omitted.)

To the Clerk of The Tax Court of the United States:

You will please prepare, transmit and deliver to the Clerk of the United States Circuit Court of Appeals for the Fifth Circuit copies, duly certified as correct, of the following documents and records in the above styled cause in connection with the Petition for Review by the said Circuit Court of Appeals for the Fifth Circuit heretofore filed by South Texas Lumber Company, in the above named petitioner:

1. Docket entries of the proceedings before The Tax Court;

2. Pleadings:

(a) Petition and attached notice of deficiency dated November 5, 1945, filed January 25, 1946;

(b) Answer of Commissioner filed March 18, 1946.

3. Stipulation of Facts filed at hearing in The Tax Court May 15, 1946;

4. Findings of Fact and Opinion of The Tax Court of the United States promulgated August 30, 1946;

5. Decision entered by The Tax Court September 9, 1946;

6. Motion of respondent to vacate decision of September 9, 1946, and for entry by The Tax Court of a new decision, filed October 7, 1946;

7. Order of The Tax Court filed October 11, 1946, amending previous decision dated September 9, 1946;

8. Petition for Review and Assignments of Error filed by petitioner on December 2, 1946;

9. Notice of filing Petition for Review and Assignments of Error, and acceptance of service by respondent filed December 4, 1946;

10. This Praecipe for Record, with respondent's acceptance of notice thereof;

11. Certificate and Seal.

J. ARTHUR PLATT,
(J. Arthur Platt),
Counsel for Petitioner on
Review.

20th Floor Sterling Building,
Houston, Texas.

Service of a copy of this Praecipe for Record is hereby accepted and agreed to on this the 9th day of December, 1946.

J. P. WENCHEL, CCR.
(J. P. Wenchel),
Chief Counsel, Bureau of
Internal Revenue.

CERTIFICATE.

The Tax Court of the United States,
Washington.

South Texas Lumber Company, Petitioner,
vs. Docket No. 10050
Commissioner of Internal Revenue, Respondent.

I, VICTOR S. MERSCH, Clerk of The Tax Court of the United States do hereby certify that the foregoing pages, 1 to 46, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Praecipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of The Tax Court of the United States, at Washington, in the District of Columbia, this 14th day of January, 1947.

VICTOR S. MERSCH,
Clerk, The Tax Court of the
United States.

(Seal)

EMT.

That thereafter the following proceedings were had in said cause in the United States Circuit Court of Appeals for the Fifth Circuit, viz:

Argument and submission.

Extract from the Minutes of June 4, 1947

No. 11,896

SOUTH TEXAS LUMBER COMPANY

v.

COMMISSIONER OF INTERNAL REVENUE

On this day this cause was called, and, after argument by J. Arthur Platt, Esq., for petitioner, and Carlton Fox, Esq., Special Assistant to the Attorney General, for respondent, was submitted to the Court.

OPINION OF THE COURT. FILED JULY 3, 1947

In the United States Circuit Court of Appeals for the Fifth Circuit

No. 11896

SOUTH TEXAS LUMBER COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Petition for Review of Decision of the Tax Court of the United States

(July 3, 1947)

Before SIBLEY, HOLMES, and WALLER, Circuit Judges

WALLER, Circuit Judge: The Taxpayer, a corporation under the laws of Texas, which keeps its books and files its income and excess profits tax returns on the calendar year and on the accrual basis, made sales of certain real estate and elected to compute and report the profit from such sales on the installment basis as provided by Sec. 44b of Internal Revenue Code. The question presented is whether or not in computing the income and excess profits tax of the corporation for the year 1943 the corporation may, for excess profits credit, include as "equity-invested capital" uncollected profits which had been accumulated on its books on January 1, 1941, from such installment sales on the theory that

such profits, although uncollected, represent "accumulated earnings and profits as of the beginning of the taxable year" under Sec. 718 (a) (4) of the Internal Revenue Code, which provides that equity-invested capital shall include "the accumulated earnings and profits as of the beginning of said taxable year; * * *"

In making the sales of the real estate on the installment plan, a deed was executed and delivered to the purchaser, with a vendor's lien retained to secure payment of the promissory notes, for the balance, which notes the purchaser had executed to the corporation. Being on the accrual basis of accounting, the corporation carried on its books as receivables all of these installment obligations, but for income tax purposes it showed as unreported income under the classification of "Unrealized Profit Installment Sales" such part of the proceeds from the installment sales that remained uncollected, and in its excess profits tax return for the year 1943 it claimed the unreported income, or that part not yet collected from the installment sales, as a part of its surplus and undivided profits in computing its equity-invested capital.

In redetermining the Taxpayer's excess profits tax for the calendar year 1943 the Commissioner reduced its equity-invested capital for the calendar years of 1941, 1942, and 1943, by the full amount of the sums so carried as unreported income or profits from those installment sales for the said three years.

The term "accumulated profits" is not defined in the excess profits tax provisions of the statutes, but Sec. 728 provides that "the terms used in this subchapter shall have the same meaning as when used in chapter 1." The Commissioner contends:

(1) That whether uncollected profits on installment sales at the beginning of the taxable year are includible in the equity-invested capital depends on whether such profits are "recognized in computing net income" as provided in Sec. 115 (1) of Chapter 1 as added by Sec. 501 (a) of the Second Revenue Act of 1940, and that since the Taxpayer did not report in its income tax return the uncollected profits under the installment sales in computing its net income, such profits, therefore, were not "recognized in computing net income" and, therefore, are not includible in the term "equity-invested capital" for excess profits tax purposes.

(2) That Congress, in enacting Sec. 115 (1), intended to approve an administrative definition of "earnings and profits" in determining the source of divided distribution under 115 (a) and that such long-standing definition should be applied in computing "earnings and profits" in determining equity-invested capital under Sec. 718 (a) (4).

(3) That Sec. 115 (1) makes "recognition" in computing net income the test, and that income that is returned under the installment sales statute (44 (a) and (b)) is so "recognized", but that the uncollected profits on these installment sales which are merely shown in the income tax return as "Unrealized Profit Installment Sales" are not included in the income tax return and hence they are not "recognized" so as to be includible in earnings and profits.

(4) That Sec. 19.115–3 of Regulations 103 expressly provided that uncollected profits shall not be included in "earnings and profits", and that the Taxpayer's attack on the definition of earnings and profits that makes "recognition" instead of "realization" the test will not result in the regulation being stricken down unless it is clearly erroneous and unreasonable.

The Taxpayer insists that income tax consequences accrue upon the realization of income rather than upon its recognition, and that under the installment plan of income tax reporting, which the statute gives it the right to adopt, there was no actual realization of the income on the unpaid balances in the installment sales such as made it appropriate to return the same, but that said unpaid balances on such installment contracts were "accumulated earnings and profits at the beginning of the taxable year" within the language and purpose of Sec. 718 (a) (4).

If the Taxpayer had returned and paid the profits that accrued on each sale in the year in which such sale was made, the Commissioner would not contend that the accumulated earnings and profits represented in the unpaid installments would not then have been includible in equity-invested capital for excess profits tax purposes. He would, however, deny to the seller of property on the installment plan, who makes his income tax return according to the optional method that Congress has allowed in 44 (b), the right to recognize in his income tax return the unrealized earnings and profits thus accumulated and accrued on its books and to take credit therefor as equity-invested capital in his excess profits tax return.

The Tax Court held with the Commissioner, citing in support of its holdings its own opinion in Kimbrell's Home Furnishings, Inc., 7 T. C. 40, which case was subsequently reversed by the Circuit Court of Appeals for the Fourth Circuit in an opinion reported at 159 F. 2d 608.

Definitely there were accumulated as a legitimate part of the corporation's surplus earnings and profits as of the beginning of the taxable year which would have been taxable (or recognized) as gains had it not been for the option given the Taxpayer under Sec. 44 (b) to defer income tax payments on profits from installment sales until the time of their realization.

It is believed that if Congress had intended to restrict the earnings and profits includible in equity-invested capital to those earnings and profits on which the corporation had in the taxable year paid income taxes, and also had intended to burden the option it had given in 44 (b) by excluding profits from installment sales from being characterized as "accumulated earnings and profits" under Sec. 718 (a) (4), it would have said so in plain words so that the Commissioner would not be called upon to resort to an argument so tenuous that it is necessary to pull in Sec. 115 (1), 501 (9), and 111 (d) to prove that Sec. 718 (a) (4) does not mean what it says.

The question has already been decided by this Court in Commissioner v. Shenandoah Company, 138 F. 2d 792, contrary to the contentions of the Commissioner, and we think the holdings annouced in that case, which were approved by the Fourth Circuit in the Kimbrell case, supra, were correct and are controlling in the present case.

In our view the decision of the Tax Court is not in accordance with law, and the same is hereby

REVERSED.

HOLMES, Circuit Judge, dissenting: I would affirm the decision of the Tax Court, since it seems to me that the decision of this court in Commissioner v. Shenendoah Company, 138 F. (2d) 792, has in principle been overruled by Commissioner v. Wheeler, 324 U. S. 542.

A true copy.
Teste.

Judgment

Extract from the Minutes of July 3, 1947

No. 11896

SOUTH TEXAS LUMBER COMPANY

v.

COMMISSIONER OF INTERNAL REVENUE

This cause came on to be heard on the petition of South Texas Lumber Company for a review of a decision of the Tax Court of the United States, and was argued by counsel;

On consideration whereof, It is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby reversed. "Holmes, Circuit Judge, dissents."

Clerk's certificate

United States of America

United States Circuit Court of Appeals, Fifth Circuit

I, Oakley F. Dodd, Clerk of the United States Circuit Court of Appeals for the Fifth Circuit, do hereby certify that the pages numbered from 51 to 58, next preceding this certificate, contain full, true, and complete copies of all the pleadings, record entires and proceedings, including the opinion of the United States Circuit Court of Appeals for the Fifth Circuit, in a certain cause in said Court, numbered 11896, wherein South Texas Lumber Company is petitioner, and Commissioner of Internal Revenue is respondent, as full, true and complete as the originals of the same now remain in my office.

I further certify that the pages of the printed record, numbered from 1 to 50, are identical with the printed record upon which said cause was heard and decided in the said United States Circuit Court of Appeals for the Fifth Circuit.

In testimony whereof, I hereunto subscribe my name and affix the seal of the said United States Circuit Court of Appeals, at my office in the City of New Orleans, Louisiana, this 8th day of September A. D. 1947.

[SEAL]

(S) OAKLEY F. DODD,
Clerk of the United States Circuit Court of Appeals, Fifth Circuit.

U. S. GOVERNMENT PRINTING OFFICE 1947

Supreme Court of the United States

Order allowing certiorari

Filed November 24, 1947

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Fifth Circuit is granted.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

771453—47

U. S. GOVERNMENT PRINTING OFFICE

FILE COPY

No. 384

In the Supreme Court of the United States

OCTOBER TERM, 1947

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

SOUTH TEXAS LUMBER COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

INDEX

CITATIONS

Miscellaneous: Page

In the Supreme Court of the United States

OCTOBER TERM, 1947

No. —

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

SOUTH TEXAS LUMBER COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Fifth Circuit entered July 3, 1947, reversing the decision of the Tax Court of the United States entered August 30, 1946.

OPINIONS BELOW

The opinion of the Tax Court (R. 30–35) is reported in 7 T. C. 669. The opinions in the Circuit Court of Appeals (R. 51–54) are not yet reported.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on July 3, 1947. (R. 54.) The juris-

diction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The taxpayer reports (for excess profits tax as well as income tax purposes) its gains from sales of real estate upon the installment basis under Section 44 of the Internal Revenue Code, whereby such gains are reported and taxed only to the extent that they are reflected in installments actually received by the taxpayer.

The question presented is whether the taxpayer may, in computing its excess profits credit for 1943, include in its equity invested capital the uncollected and unreported profits from such installment sales, on the theory that they represent "accumulated earnings and profits" under Section 718 (a) (4) of the Code.

STATUTES AND REGULATIONS INVOLVED

The pertinent statute and Treasury Regulations are set out in the Appendix, *infra,* pp. 16–26.

STATEMENT

The Tax Court found the facts as stipulated (R. 31–34) which, so far as material here, are as follows:

South Texas Lumber Company, hereinafter referred to as the taxpayer, is a corporation organized on September 17, 1902, under the laws of the State of Texas with its principal place of business

as a retail dealer in lumber and building material located in Houston, within the First Collection District of Texas. (R. 31.)

The taxpayer keeps its books and files its income and excess profits tax returns on the calendar year and accrual basis. (R. 31.)

During the course of its business life, the taxpayer acquired title to certain real estate situated in the State of Texas. Beginning with the taxable year 1937, the taxpayer has made sales of portions of such real estate and, in accordance with Section 44 (b) of the Internal Revenue Code, has elected to compute and report the profit thereon on the installment basis. In each of the transactions where the taxpayer made such real estate installment sales, deeds were given to purchasers, and the deferred payments were evidenced by promissory notes executed by the purchaser, payable to the order of the taxpayer as therein shown, and were secured by vendor's lien and mortgage lien against the land. The taxpayer, being on the accrual basis of accounting, carried on its books as receivables all of the installment obligations so received by it from such sales. (R. 31.)

At the time provided by law, the taxpayer filed corporation income tax (Form 1120) and corporation excess profits tax (Form 1121) returns for the calendar years 1941, 1942 and 1943, disclosing net income and income taxes due thereon for the three years and excess profits tax for the calendar

year 1943. In arriving at the net income for the three years, the taxpayer reported the following realized profits on the installment sales previously referred to above (R. 33):

	1941	1942	1943
1937 sales	$3,043.49	$2,136.34	$2,396.87
1938 sales	903.70	1,135.81	403.13
1941 sales	21.84	196.56	190.98
Total	3,969.03	3,468.71	2,990.98

The balance sheets attached to and made a part of the income tax returns disclosed the following unreported income from installment sales classified as "Unrealized Profit Installment Sales" (R. 33):

	12-31-40	12-31-41	12-31-42	12-31-43
1937	$8,541.39	$5,497.90	$3,361.56	$964.69
1938	2,442.64	1,538.94	403.13	0
1941	0	1,070.36	873.80	682.82
Total	10,984.03	8,107.20	4,638.49	1,647.51

In its corporation excess profits tax return, Form 1121, for the calendar year 1943, the taxpayer claimed the unreported income from installment sales, $4,638.49, as a part of surplus and undivided profits in arriving at its equity invested capital. It also claimed the unreported income from installment sales, $10,984.03, as at December 31, 1940, and $8,107.20 as at December 31, 1941, in arriving at its equity invested capital for the calendar years 1941 and 1942, respectively, for the purpose of its unused excess profits credit carryover from the calendar years 1941 and 1942 to the calendar year 1943. (R. 33–34.)

The tax in controversy in this case is the excess

profits tax for the calendar year 1943. The Commissioner, as disclosed by the statutory notice of deficiency dated November 5, 1945, reduced the taxpayer's equity invested capital for the calendar years 1941, 1942 and 1943 by the amounts of unreported profits from installment sales previously referred to above in the respective amounts of $10,984.03, $8,107.20 and $4,638.49. (R. 34.)

The Tax Court sustained the Commissioner's determination (R. 35), but the court below reversed the Tax Court's decision (R. 54).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

(1) In holding that the taxpayer, which reported its profits from sales of real estate for income and excess profits tax for the taxable year 1943 on the installment basis of return under Section 44 (b) of the Internal Revenue Code, may for excess profits tax purposes include in its equity invested capital uncollected and unreported profits from such installment sales of real estate outstanding on its books as of January 1, 1941, 1942, and 1943, on the theory that these profits represent "accumulated earnings and profits as of the beginning of such taxable year," under Section 718, (a) (4) of the Code.

(2) In failing to hold that subsection (l) of Section 115, defining "earnings and profits," is applicable to a determination of the taxpayer's "accumulated earnings and profits as of the be-

ginning of such taxable year" under Section 718 (a) (4) for the purpose of computing its equity invested capital for excess profits credit purposes.

(3) In failing to apply Section 29.115–3 and Section 29.115–12 of Treasury Regulations 111, promulgated under the income tax provisions of the Code, and Section 35.718–2 of Treasury Regulations 112, promulgated under the excess profits tax provisions thereof, in the determination of the taxpayer's "accumulated earnings and profits at the beginning of such taxable year", in computing its equity invested capital for excess profits credit purposes under Section 718 (a) (4).

(4) In failing to hold that uncollected and unreported profits of the taxpayer on installment sales are not "recognized" for tax purposes under Sections 44, 111 and 112 of the Internal Revenue Code and may not be included in "accumulated earnings and profits" under Section 718 (a) (4).

(5) In reversing the Tax Court's decision.

REASONS FOR GRANTING THE WRIT

1. In determining a corporation's "equity invested capital" for excess profits tax purposes, Section 718 (a) (4) of the Internal Revenue Code provides that there shall be included its "accumulated earnings and profits" as of the beginning of the taxable year.[1] The question in this case is

[1] The excess-profits tax is imposed with respect to profits in excess of a specified credit, and that credit may be based upon stated percentages of the corporation's "invested cap-

whether the taxpayer may include uncollected and unreported profits on installment sales in determining its "earnings and profits" under Section 718 (a) (4), thereby increasing its excess profits credit. The taxpayer keeps its books on the accrual basis, but it has taken advantage of the privilege accorded to it by Section 44 (b) of the Code, to compute and report on the installment basis the profits made on installment sales of real estate. Thus, the profit on a particular sale is allocated to the various installments, and the taxpayer reports proportionate amounts of the profit and pays a tax thereon only as the installments are actually received. In accordance with that method, the taxpayer was not required to and in fact did not report as income any gain on its sales that was attributable to installments which it had not yet received. However, it nevertheless insists, and the court below so held, reversing the Tax Court, that it may include such unreported and uncollected gains in computing its "earnings and profits."

The result thus reached by the court below is not only in conflict with the basic statutory scheme, but it renders invalid a Treasury Regulation which explicitly requires that a corpora-

---

ital." Secs. 710, 711, 712, 714. The invested capital is defined to consist of the sum of the corporation's "equity invested capital" and its "borrowed invested capital." Sec. 717. And Section 718 spells out in detail the method of computing "equity invested capital."

762200—47——2

tion computing its income on the installment basis must also compute its "earnings and profits" on the same basis. Section 29.115–3 of Regulations 111. The erroneous decision below not only affects the excess profits tax liability of all corporations that reported income on the installment basis, but it also has much wider application with respect to income taxes generally in that it embodies a concept of "earnings and profits" which directly affects the question whether a corporation distributes taxable dividends to its stockholders.[2] It is therefore a matter of great importance to the orderly administration of the tax laws that the decision below be reviewed.

2. The decision below is sharply at variance with the statutory scheme and the applicable Treasury regulations. Section 115 (l) of the Internal Revenue Code, after describing the method of determining gain or loss from the sale of property by a corporation for the purpose of computing its "earnings and profits," explicitly

---

[2] A corporate distribution to stockholders results in a taxable dividend only if it is paid out of "earnings and profits." Section 115 (a) of the Internal Revenue Code. And long-standing administrative practice has treated distributions as not constituting dividends where they were paid out of gains which had not yet been recognized by the corporation for its income tax purposes. If the decision below properly reflects the law applicable to determining the "earnings and profits" available for distribution, it may be necessary for the Commissioner to reopen the tax liabilities of stockholders for past years (to the extent not barred by limitations) and to assert deficiencies based upon this decision.

provides: "Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made." And if there were otherwise any doubt in this regard, Section 29.115–3 of Regulations 111, makes it doubly clear that profits reflected in unpaid installments (which have not been reported as income by reason of Section 44 of the Code) are not to be included in the corporation's earnings and profits. These regulations unambiguously provide that "* * * a corporation computing income on the installment basis as provided in section 44 shall, with respect to the installment transactions, compute earnings and profits on such basis * * *." These provisions are further fortified by Section 29.115–12, which states:

> The gain or loss so realized [upon sale of property] increases or decreases the earnings and profits to, but not beyond, the extent to which such gain or loss was *recognized* in computing net income under the law applicable to the year in which such sale or disposition was made. As used in this subsection the term "recognized" has reference to that kind of realized gain or loss which is recognized for income tax purposes by the statute applicable to the year in which the gain or loss was realized, for

example, see section 112.[3] * * * * [Italics in original.]

Moreover, the regulations make it plain that these provisions apply to excess profits taxes as well as ordinary income taxes. Section 29.115–12 states that the rules for determining gain or loss under Section 115 (l) of the Code "are applicable whenever under any provision of chapter 1 [containing the ordinary income tax provisions]

[3] The provisions of Section 29.115–12 quoted above show that they are not limited to gains or losses the recognition of which is governed exclusively by Section 112, since it refers to Section 112 with the words "for example." Accordingly, these provisions are also applicable to recognition or non-recognition under the installment sales provisions of Section 44, as is made clear by Section 29.115–3, quoted above, which explicitly refers to Section 44.

But even if it were necessary to bring the case within Section 112, it is persuasive from an examination of the statute that the provisions of Section 44 are to be regarded as read into Section 112. For, Section 112 (a) declares that the entire amount of gain or loss, determined under Section 111 shall be recognized, except as thereinafter [i. e., in Section 112] provided. Although none of the exceptions applies to installment sales, it seems plain that the general reference to Section 111 brings into play not merely Section 111 (c) (which refers to Section 112 to determine the extent of recognition of gain or loss upon sale) but also Section 111 (d) (which deals exclusively with installment sales and takes into account the special provisions of law governing such sales). Accordingly, it may fairly be said that the reference in Section 112 (a) to Section 111, which in turn takes installment sales into account, assimilates the installment sales non-recognition provisions of Section 44 with like provisions in Section 112. In short, the gain on an installment sale is "recognized" under Sections 111 and 112 to the extent that it is subjected to tax in a given year under Section 44.

or 2 [containing the excess profits tax provisions] it is necessary to compute either the total earnings and profits of the corporation or * * *." And the same section also describes the total earnings and profits of a corporation as being "of most frequent application in determining invested capital", which is relevant only for excess profits tax purposes. Furthermore, Section 728 of the Code provides that "The terms used in this subchapter [i. e., the subchapter which imposes the excess profits tax] shall have the same meaning as when used in Chapter 1 [the chapter which imposes the ordinary income taxes and which contains such provisions as Section 115]." See Appendix, *infra,* p. 22. And Section 35.718–2 of Treasury Regulations 112, promulgated with respect to the excess profits taxes, refers specifically to Section 115 and accompanying regulations for the meaning of the term "accumulated earnings and profits."[4] See Appendix, *infra,* p. 25.

[4] If there were any residual doubts as to the applicability of Section 115 (l) and the regulations under Section 115 with respect to excess profits taxes, these doubts would be resolved by the legislative history of the statute which added Section 115 (l) to the Code. Thus the report of the House Ways and Means Committee pointed out that the new provisions were intended to clarify the meaning of the term "earnings and profits," and that "this is important not only for the purpose of determining whether distributions are taxable dividends *but also in determining equity invested capital for excess-profits-tax purposes.*" [Italics supplied.] H. Rep. 2894, 76th Cong., 3d Sess., p. 41. See also H. Rep. 3002 [conference report], 76th Cong., 3d Sess., p. 60. These new

3. The decision below is in conflict with the principles recognized by this Court in *Commissioner* v. *Wheeler,* 324 U. S. 542. Although the validity of the retroactive provisions of Section 501 (a) of the Second Revenue Act of 1940 [which added Section 113 (l) to the Internal Revenue Code] was ostensibly involved, this Court found it unnecessary to pass upon the constitutional issue. For, it held that the new provisions were simply declaratory of pre-existing law, as reflected in outstanding valid regulations. The particular regulation upheld was Article 115–3 of Treasury Regulations 101 which provided, *inter alia,* that "Gains and losses within the purview of section 112 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section." The Court thus disapproved, at least impliedly, such decisions as *Commissioner* v. *F. J. Young Corp.,* 103 F. 2d 137 (C. C. A. 3) which were the immediate cause for the legislation before the Court in the *Wheeler*

---

provisions were undoubtedly submitted in response to the recommendations of a subcommittee of the House Ways and Means Committee, dated August 8, 1940, entitled "Proposed Excess-Profits Taxation and Special Amortization—1940" (76th Cong., 3d Sess.), p. 14. The subcommittee recommended that the term "earnings and profits" as used in Chapter 1 be "clarified" in order that the unrecognized gain or loss on the sale of property by a corporation be not reflected in its earnings and profits account.

case.[5] However, cases such as the *F. J. Young Corp.* case were the basis for the decision in *Commissioner* v. *Shenandoah Co.*, 138 F. 2d 792 (C. C. A. 5), which the court below regarded as controlling in the present case. But the *Wheeler* case, in recognizing the validity of the regulations involved, destroyed the entire structure upon which this line of cases rested. The dissenting opinion of Judge Holmes in the court below regarded the *Shenandoah Co.* case as having been overruled "in principle" (R. 54) by the *Wheeler* case, thus removing the very foundation upon which the majority placed its decision.[6]

---

[5] See H. Rep. 2894, 76th Cong., 3d Sess., p. 42, which refers to the *Young* case by name as the type of situation to which the new legislation was addressed. As indicated above, this new legislation added Section 115 (l) to the Internal Revenue Code. The *Young* case had held, contrary to the regulations sustained in the *Wheeler* case, that gains which were realized were to be included in a corporation's earnings and profits, notwithstanding that such gains had not yet been *recognized* for income tax purposes. The new provisions added in Section 115 (l) were thus intended as a legislative reversal of the *Young* case. However, this Court's decision in the *Wheeler* case is to the effect that the new legislation was simply declaratory of prior law, with the consequence that the *Young* case must be regarded as having been erroneously decided.

[6] The majority also noted (R. 53–54) that the decision in *Kimbrell's Home Furnishings, Inc.* v. *Commissioner*, 7 T. C. 339, which was in accord with the Tax Court's decision in the present case had been reversed in the Fourth Circuit (159 F. 2d 608). Whatever may be said as to the correctness of that reversal, however, the *Kimbrell's* case differs from the present case in a crucial respect. In the *Kimbrell's* case, the taxpayer

4. The decision below is in conflict with decisions of the Court of Claims and the Circuit Courts of Appeals for the Second and Ninth Circuits under a corresponding provision of prior law. The same issue as is involved in this case arose on numerous occasions under Section 326 (a) (3) of the Revenue Act of 1918 (c. 18, 40 Stat. 1057) with respect to the war-profits and excess-profits tax then in effect. This provision reads as follows:

> SEC. 326. (a) That as used in this title the term "invested capital" for any year means (except as provided in subdivisions (b) and (c) of this section):
>
> * * * * *
>
> (3) Paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during the year;

Although the language of this provision is not identical with Section 718 (a) (4) of the Code, here involved, both provisions in effect require the inclusion of accumulated earnings and profits

---

had taken advantage of an option in Section 736 (a) of the Code, whereby it accrued (for excess profits tax purposes) its gains on installment sales in the year that sales were made, and actually paid taxes with respect to such gains. Such gains were thus in fact *recognized* for excess profits tax purposes and were therefore included in the corporation's "earnings and profits." In the present case, on the other hand, the gains involved have not been accrued in the years of the sales; these gains, reflected in uncollected installments, were *not recognized* and therefore not reported during the years involved.

in invested capital. And under the 1918 Act, it was uniformly held that uncollected gains on installment sales in the case of taxpayers reporting on the installment basis are not to be included in earnings of the taxpayer for the purpose of determining its invested capital. See e. g., *Schmoller & Mueller Piano Co.* v. *United States*, 67 C. Cls. 428; *John M. Brant Co.* v. *United States*, 40 F. 2d 126 (C. Cls.), certiorari denied, 282 U. S. 888; *Standard Computing Scale Co.* v. *United States*, 52 F. 2d 1018 (C. Cls.); *Jacob Bros. Co.* v. *Commissioner*, 50 F. 2d 394 (C. C. A. 2); *Tull & Gibbs* v. *United States*, 48 F. 2d 148 (C. C. A. 9).

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

PHILIP B. PERLMAN,
Solicitor General.

OCTOBER, 1947.

APPENDIX

Internal Revenue Code:

CHAPTER 1—INCOME TAX

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year. (26 U. S. C. 1940 ed., Sec. 41.)

SEC. 42. [As amended by Section 114 of the Revenue Act of 1941, c. 412, 55 Stat. 687]. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.—

(a) *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. In the case of the death of a tax-

payer there shall be included in computing net income for the taxable period in which falls the date of his death, amounts accrued up to the date of his death if not otherwise properly includible in respect of such period or a prior period.

* * * * *

(26 U. S. C. 1940 ed., Sec. 42.)

SEC. 44. INSTALLMENT BASIS.

(a) *Dealers in Personal Property.*—Under regulations prescribed by the Commissioner with the approval of the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed, bears to the total contract price.

(b) *Sales of Realty and Casual Sales of Personality* [*sic*].—In the case (1) of a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year), for a price exceeding $1,000, or (2) of a sale or other disposition of real property, if in either case the initial payments do not exceed 30 per centum of the selling price (or, in case the sale or other disposition was in a taxable year beginning prior to January 1, 1934, the percentage of the selling price prescribed in the law applicable to such year), the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the basis and in the manner above prescribed in this section. As used in this section the term "initial payments"

means the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made.

* * * * *

(26 U. S. C. 1940 ed., Sec. 44.)

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

(c) *Recognition of Gain or Loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this chapter, shall be determined under the provisions of section 112.

(d) *Installment Sales.*—Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received.

(26 U. S. C. 1940 ed., Sec. 111.)

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or

exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

* * * * *

(26 U. S. C. 1940 ed., Sec. 112.)

SEC. 115. DISTRIBUTION BY CORPORATIONS.

* * * * * *

(l) [as added by Section 501 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974, 1004] *Effect on Earnings and Profits of Gain or Loss and of Receipt of Tax-Free Distributions.*—The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

(1) for the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law appli-

cable to the year in which such sale or disposition was made. * * *

* * * * *

(26 U. S. C. 1940 ed., Sec. 115.)

CHAPTER 2—ADDITIONAL INCOME TAXES

SUBCHAPTER A—PERSONAL HOLDING COMPANIES.

* * * * *

SUBCHAPTER B [as amended by Section 506 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974]—DECLARED VALUE EXCESS-PROFITS TAX.

* * * * *

SUBCHAPTER C—EXCESS PROFITS ON NAVY CONTRACTS.

* * * * *

SUBCHAPTER D—UNJUST ENRICHMENT.

* * * * *

SUBCHAPTER E—EXCESS PROFITS TAX [as added by Section 201 of the Second Revenue Act of 1940, supra, which provided that the new subchapter may be cited as the "Excess Profits Tax Act of 1940"].

SEC. 712 [as amended by Sec. 13 of the Act of March 7, 1941, c. 10, 55 Stat. 17]. EXCESS PROFITS CREDIT-ALLOWANCE.

(a) *Domestic Corporations.*—In the case of a domestic corporation which was in existence before January 1, 1940, the excess profits credit for any taxable year shall be an amount computed under section 713 or section 714, whichever amount results in the lesser tax under this subchapter for the taxable year for which the tax under this subchapter is being computed. In the case of all other domestic corporations the excess

profits credit for any taxable year shall be an amount computed under section 714.

* * *

* * * * *

(26 U. S. C. 1940 ed., Supp. V, Sec. 712.)

SEC. 714 [as amended by Sec. 217 of the Revenue Act of 1942, c. 619, 56 Stat. 798]. EXCESS PROFITS CREDIT—BASED ON INVESTED CAPITAL.

The excess profits credit, for any taxable year, computed under this section, shall be the amount shown in the following table:

If the invested capital for the taxable year, determined under section 715, is:	The credit shall be:
Not over $5,000,000---	8% of the invested capital.

* * * * * *

(26 U. S. C. 1940 ed., Supp. V, Sec. 714.)

SEC. 715. DEFINITION OF INVESTED CAPITAL.

For the purposes of this subchapter the invested capital for any taxable year shall be the average invested capital for such year, determined under section 716, reduced by an amount computed under section 720 (relating to inadmissible assets). If the Commissioner finds that in any case the determination of invested capital, on a basis other than a daily basis, will produce an invested capital differing by not more than $1,000 from an invested capital determined on a daily basis, he may, under regulations prescribed by him with the approval of the Secretary, provide for such determination on such other basis. (For computation of invested capital in case of foreign corporations and corporations entitled to the benefits of section 251, see section 724.) (26 U. S. C. 1940 ed., Sec. 715.)

SEC. 716. AVERAGE INVESTED CAPITAL.

The average invested capital for any taxable year shall be the aggregate of the daily invested capital for each day of such taxable year, divided by the number of days in such taxable year. (26 U. S. C. 1940 ed., Sec. 716.)

SEC. 717. DAILY INVESTED CAPITAL.

The daily invested capital for any day of the taxable year shall be the sum of the equity invested capital for such day plus the borrowed invested capital for such day determined under section 719. (26 U. S. C. 1940 ed., Sec. 717.)

SEC. 718. EQUITY INVESTED CAPITAL.

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

* * * * *

(4) *Earnings and Profits at Beginning of Year.*—The accumulated earnings and profits as of the beginning of such taxable year;

* * * * *

(26 U. S. C. 1940 ed., Sec. 718.)

SEC. 728. MEANING OF TERMS USED.

The terms used in this subchapter shall have the same meaning as when used in Chapter 1. (26 U. S. C. 1940 ed., Sec. 728.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.115–3. *Earnings or Profits.*—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or ac-

cumulated prior to March 1, 1913) due consideration must be given to the facts, and, while mere bookkeeping entries increasing or decreasing surplus will not be conclusive, the amount of the earnings or profits in any case will be dependent upon the method of accounting properly employed in computing net income. For instance, a corporation keeping its books and filing its income tax returns under sections 41, 42, and 43 on the cash receipts and disbursements basis may not use the accrual basis in determining earnings and profits; a corporation computing income on the installment basis as provided in section 44 shall, with respect to the installment transactions, compute earnings and profits on such basis; and an insurance company subject to taxation under section 204 shall exclude from earnings and profits that portion of any premium which is unearned under the provisions of section 204 (b) (5) and which is segregated accordingly in the unearned premium reserve.

* * * Gains and losses within the purview of section 112 or corresponding provisions of prior Revenue Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section (see section 29.115–12). * * *

* * * * *

SEC. 29.115–12. *Effect on Earnings and Profits of Gain or Loss Realized After February 28, 1913.*—In order to determine the effect on earnings and profits of gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation, section 115 (l) prescribes certain rules for (1) the computation of the total earnings and profits of the corpo-

ration, of most frequent application in determining invested capital; and (2) the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, of most frequent application in determining the source of dividend distributions. Such rules are applicable whenever under any provision of chapter 1 or 2 it is necessary to compute either the total earnings and profits of the corporation or the earnings and profits for any period beginning after February 28, 1913. * * *

The gain or loss so realized increases or decreases the earnings and profits to, but not beyond, the extent to which such gain or loss was *recognized* in computing net income under the law applicable to the year in which such sale or disposition was made. As used in this subsection the term "recognized" has reference to that kind of realized gain or loss which is recognized for income tax purposes by the statute applicable to the year in which the gain or loss was realized, for example, see section 112. A loss (other than a wash sale loss with respect to which a deduction is disallowed under the provisions of section 118 or corresponding provisions of prior revenue laws) may be recognized though not allowed as a deduction (by reason, for example, of the operation of sections 24 (b) and 117 and corresponding provisions of prior revenue laws) but the mere fact that it is not allowed does not prevent decrease in earnings and profits by the amount of such disallowed loss. Wash sale losses, however, disallowed under section 118 and corresponding provisions of prior revenue laws, are deemed nonrecognized losses and do not

reduce earnings or profits. The "recognized" gain or loss for the purpose of computing earnings and profits is determined by applying the recognition provisions to the realized gain or loss computed under the provisions of section 115 (l) as distinguished from the realized gain or loss used in computing net income. The application of this paragraph may be illustrated by the following examples: * * *

* * * * *

Treasury Regulations 112, promulgated under the Internal Revenue Code:

SEC. 35.718–2. *Determination of Daily Equity Invested Capital—Accumulated Earnings and Profits.*—(a) *In general*—The term "accumulated earnings and profits" is not defined in the Internal Revenue Code. See, however, section 115 and the regulations prescribed thereunder as to the effect of certain transactions on earnings and profits, and section 35.718–5 as to the effect of the declaration and distribution of dividends. In general, the concept of "accumulated earnings and profits" for the purpose of the excess profits tax is the same as for the purpose of the income tax.[1]

* * *

SEC. 35.718–6. *Determination of Daily Equity Invested Capital—Reduction by Earnings and Profits of Another Corporation.*—Section 718 (b) (3) provides for the elimination of the duplication which occurs in the computation of the equity invested

[1] Substantially the same provision appeared in Section 30.718–2 of Treasury Regulations 109, promulgated in 1941 under the Internal Revenue Code as amended by the Second Revenue Act of 1940.

capital of the taxpayer following a transaction of the character referred to therein, as a result of which the earnings and profits of another corporation became the earnings and profits of the taxpayer. The earnings and profits of such other corporation having been included at the time of the transaction in the earnings and profits of the taxpayer, they remain continuously thereafter a part of such earnings and profits account for the purpose of computing for any day after such transaction the earnings and profits, the accumulated earnings and profits at the beginning of the taxable year, and the earnings and profits of the taxable year. In addition, however, the amount of such included earnings and profits is also brought into computation of equity invested capital of the taxpayer under provisions of section 718 other than section 718 (a) (4) relating to accumulated earnings and profits as of the beginning of the taxable year. * * *

* * * * *

U. S. GOVERNMENT PRINTING OFFICE: 1947

FILE COPY

No. 384

In the Supreme Court of the United States

OCTOBER TERM, 1947

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

SOUTH TEXAS LUMBER COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE PETITIONER

INDEX

CITATIONS

Cases:

Statutes—Continued

In the Supreme Court of the United States

OCTOBER TERM, 1947

No. 384

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

SOUTH TEXAS LUMBER COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Tax Court (R. 30–35) is reported in 7 T. C. 669. The opinions in the Circuit Court of Appeals (R. 51–54) are reported in 162 F. 2d 866.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on July 3, 1947. (R. 54.) The petition for a writ of certiorari was filed October 3, 1947, and was granted November 24, 1947 (R. 56). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial

Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The taxpayer reports (for excess profits tax as well as income tax purposes) its gains from sales of real estate upon the installment basis under Section 44 of the Internal Revenue Code, whereby such gains are reported and taxed only to the extent that they are reflected in installments actually received by the taxpayer.

The question presented is whether the taxpayer may, in computing its excess profits credit for 1943, include in its equity invested capital the uncollected and unreported profits from such installment sales, on the theory that they represent "accumulated earnings and profits" under Section 718 (a) (4) of the Code.

STATUTES AND REGULATIONS INVOLVED

The pertinent statute and Treasury Regulations are set out in the Appendix, *infra*, pp. 34–48.

STATEMENT

The Tax Court found the facts as stipulated (R. 31–34) which, so far as material here, are as follows:

South Texas Lumber Company, hereinafter referred to as the taxpayer, is a corporation organized on September 17, 1902, under the laws of the State of Texas with its principal place of business as a retail dealer in lumber and building material located in Houston. It keeps its

books and files its income and excess profits tax returns on the calendar year and accrual basis. (R. 31.)

During the course of its business life, the taxpayer acquired title to certain real estate situated in the State of Texas. Beginning with the taxable year 1937, the taxpayer has made sales of portions of such real estate and, in accordance with Section 44 (b) of the Internal Revenue Code, has elected to compute and report the profit thereon on the installment basis. In each of the transactions where the taxpayer made such real estate installment sales, deeds were given to purchasers, and the deferred payments were evidenced by promissory notes executed by the purchaser, payable to the order of the taxpayer as therein shown, and were secured by vendor's lien and mortgage lien against the land. The taxpayer, being on the accrual basis of accounting, carried on its books as receivables all of the installment obligations so received by it from such sales. (R. 31.)

At the time provided by law, the taxpayer filed corporation income tax (Form 1120) and corporation excess profits tax (Form 1121) returns for the calendar years 1941, 1942 and 1943, disclosing net income and income taxes due thereon for the three years and excess profits tax for the calendar year 1943. In arriving at the net income for the three years, the taxpayer re-

ported the following realized profits on the installment sales referred to above (R. 33):

	1941	1942	1943
1937 sales	$3,043.49	$2,136.34	$2,396.87
1938 sales	903.70	1,135.81	403.13
1941 sales	21.84	196.56	190.98
Total	3,969.03	3,468.71	2,990.98

The balance sheets attached to and made a part of the income tax returns disclosed the following unreported income from installment sales classified as "Unrealized Profit Installment Sales" (R. 33):

	12-31-40	12-31-41	12-31-42	12-31-43
1937	$8,541.39	$5,497.90	$3,361.56	$964.69
1938	2,442.64	1,538.94	403.13	0
1941	0	1,070.36	873.80	682.82
Total	10,984.03	8,107.20	4,638.49	1,647.51

In its corporation excess profits tax return, Form 1121, for the calendar year 1943, the taxpayer claimed the unreported income from installment sales, $4,638.49 as at December 31, 1942, as a part of surplus and undivided profits in arriving at its equity invested capital. It also claimed the unreported income from installment sales, $10,984.03 as at December 31, 1940, and $8,107.20 as at December 31, 1941, in arriving at its equity invested capital for the calendar years 1941 and 1942, respectively, for the purpose of its unused excess profits credit carryover from the

calendar years 1941 and 1942 to the calendar year 1943. (R. 33–34.)

The tax in controversy in this case is the excess profits tax for the calendar year 1943. The Commissioner, as disclosed by the statutory notice of deficiency dated November 5, 1945, reduced the taxpayer's equity invested capital for the calendar years 1941, 1942 and 1943 by the amounts of unreported profits from installment sales previously referred to above in the respective amounts of $10,984.03, $8,107.20 and $4,638.49. (R. 34.)

The Tax Court sustained the Commissioner's determination (R. 35), but the court below reversed the Tax Court's decision (R. 54).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

(1) In holding that the taxpayer, which reported its profits from sales of real estate for income and excess profits tax for the taxable year 1943 on the installment basis of return under Section 44 (b) of the Internal Revenue Code, may for excess profits tax purposes include in its equity invested capital uncollected and unreported profits from such installment sales of real estate outstanding on its books as of January 1, 1941, 1942, and 1943, on the theory that these profits represent "accumulated earnings and profits as

of the beginning of such taxable year," under Section 718 (a) (4) of the Code.

(2) In failing to hold that subsection (l) of Section 115, defining "earnings and profits," is applicable to a determination of the taxpayer's "accumulated earnings and profits as of the beginning of such taxable year" under Section 718 (a) (4) for the purpose of computing its equity invested capital for excess profits credit purposes.

(3) In failing to apply Section 29.115–3 and Section 29.115–12 of Treasury Regulations 111, promulgated under the income tax provisions of the Code, and Section 35.718–2 of Treasury Regulations 112, promulgated under the excess profits tax provisions thereof, in the determination of the taxpayer's "accumulated earnings and profits as of the beginning of such taxable year," in computing its equity invested capital for excess profits credit purposes under Section 718 (a) (4).

(4) In failing to hold that uncollected and unreported profits of the taxpayer on installment sales are not "recognized" for tax purposes under Sections 44, 111, and 112 of the Internal Revenue Code and may not be included in "accumulated earnings and profits" under Section 718 (a) (4).

(5) In reversing the Tax Court's decision.

SUMMARY OF ARGUMENT

The taxpayer, although reporting gain from installment sales upon the installment basis, as provided for in Section 44 of the Internal Revenue Code, for purposes of both the income tax and

the excess profits tax, seeks to disregard that basis in computing its "accumulated earnings and profits" which enter into the computation of equity invested capital under Section 718 (a) (4) of the Code. This is directly contrary to Treasury Regulations which provide that the amount of the earnings and profits in any case will be dependent upon the method of accounting properly employed in computing net income and which specifically direct that a corporation computing income on the installment basis as provided in Section 44 shall, with respect to the installment transactions, compute earnings and profits on such basis. Section 29.115–3, Regulations 111.

These Regulations are valid and should be sustained. (1) They are in accord with numerous decisions rendered under the excess profits tax provisions of the Revenue Act of 1918 which held that uncollected gains on installment sales in the case of taxpayers reporting on the installment basis are not to be included in earnings of the taxpayer for the purpose of determining "earned surplus and undivided profits," which was one of the elements of invested capital under that Act. (2) The same principles which led this Court in *Commissioner* v. *Wheeler*, 324 U. S. 542, to sustain a portion of the Regulations here pertinent require the conclusion that these Regulations are valid. (3) The installment basis of return of gain from sales of property is an

approved, independent statutory method of return, and it is an established principle that the same method employed in computing and reporting gains for income tax purposes must be used in determining earnings and profits. (4) Section 115 (l) and Sections 111 and 112 of the code support the validity of the Regulations. Section 115 (l) provides, among other things, that realized gain or loss "shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made." Sections 111 and 112 deal with the determination of the amount of, and the recognition of, gain or loss.

It is apparent that, with respect to the time when realized and recognized gain shall enter into the computation of net income and into the computation of earnings and profits, Sections 111 and 112 are superimposed upon the methods of accounting provided for in Sections 41 to 44, inclusive. Under Section 44, pertaining to the installment basis, gains are realized and recognized when installment payments are actually received in cash. Since under that basis the taxpayer's uncollected profits on installment sales are not deemed to have been realized and recognized for the purpose of computing net income, they may not enter into the computation of the

taxpayer's "accumulated earnings and profits" within the meaning of Section 718 (a) (4).

The court below, in holding that the taxpayer's accumulated earnings and profits should be increased by the amount of its uncollected profits on installment sales, has erroneously construed Section 115 (l) and has erroneously refused to give proper effect to valid Regulations of the Treasury Department.

ARGUMENT

THE TAXPAYER MAKING ITS RETURNS ON THE INSTALLMENT BASIS UNDER SECTION 44 OF THE INTERNAL REVENUE CODE MAY NOT INCLUDE IN ITS EQUITY INVESTED CAPITAL UNDER SECTION 718 (a) (4) OF THE CODE UNCOLLECTED PROFITS FROM SUCH SALES

Introductory

In the taxable year 1943, and in years prior thereto, the taxpayer's income from installment sales was reported by it on the installment basis under Section 44 (a) and (b) of the Internal Revenue Code (Appendix, *infra,* p. 36), both for purposes of income tax and excess profits tax. Under the installment basis, as provided for in Section 44, a taxpayer returns as income in any taxable year that portion of installment payments actually received in that year which the gross profit realized or to be realized from a sale bears to the total contract price. Thus, in the taxable year 1943, and in prior years, the taxpayer has included in the computation of income, for excess profits tax purposes, as well as for income tax

purposes, gains from installment sales only to the extent that such gains were represented in installment payments actually received by it in cash, and the taxpayer was not required to and in fact did not report as income for either income or excess profits tax purposes any gains on its sales that were attributable to installments which it had not yet received.

At the beginning of the years 1941, 1942 and 1943, the uncollected and untaxed profits on installment sales made by the taxpayer aggregated the respective amounts of $10,984.03, $8,107.20, and $4,638.49. In its corporation excess profits tax return for the calendar year 1943, the taxpayer, in arriving at its equity invested capital,[1] included the unreported income from installment sales as of the beginning of that year ($4,638.49) as part of its "accumulated earnings and profits as of the beginning of such taxable year" within the meaning of Section 718 (a) (4) (Appendix *infra*, p. 43). It also included the unreported profits from installment sales as at January 1, 1941, and as at January 1, 1942 (amounting, respectively, to $10,984.03 and $8,107.20), in arriv-

[1] The excess profits tax is imposed with respect to profits in excess of a specified credit, and that credit may be based upon the stated percentages of the corporation's "invested capital." Sections 710, 711, 712 and 714. The invested capital is defined to consist of the sum of the corporation's "equity invested capital" and its "borrowed invested capital." Section 717. Section 718 spells out in detail the method of computing "equity invested capital."

ing at its equity invested capital for the calendar years 1941 and 1942, respectively, for the purpose of its unused excess profits credit carryover from the years 1941 and 1942 to the taxable year 1943, here involved, allowed under Section 710 (b) (3). The Commissioner eliminated the items of uncollected and unreported profits from taxpayer's "accumulated earnings and profits" in arriving at taxpayer's equity invested capital, and accordingly determined a deficiency in excess profits tax for the year 1943.

The sole question presented is whether the term "accumulated earnings and profits" used in Section 718 (a) (4) of the Code embraces uncollected and unreported profits from installment sales of a taxpayer which employs for both income and excess profits tax purposes the installment method of reporting provided for in Section 44. The Tax Court sustained the Commissioner's determination on the authority of its own decision in the case of *Kimbrell's Home Furnishings, Inc.* v. *Commissioner*, 7 T. C. 339.[2] The Circuit Court

[2] The *Kimbrell's* case was subsequently reversed by the Circuit Court of Appeals for the Fourth Circuit (159 F. 2d 608). The installment basis taxpayer in that case had elected under Section 736 (a), added to the Internal Revenue Code by Section 222 (d) of the Revenue Act of 1942, c. 619, 56 Stat. 798, to compute its income from installment sales upon the *accrual basis* for purposes of the excess profits tax, while the taxpayer in the present case has remained on the installment basis for both income and excess profits tax purposes. The Tax Court's decision in favor of the Commissioner in that case was based upon the propositions (1) that a taxpayer re-

of Appeals for the Fifth Circuit reversed on the authority of its earlier decision in *Commissioner* v. *Shenandoah Co.*, 138 F. 2d 792.

The case of *Commissioner* v. *Shenandoah Co.*, like the present case, involved a taxpayer generally upon the accrual basis, but which employed the installment basis under Section 44 for reporting its income from installment sales. Unlike the present case, the *Shenandoah Co.* case did not involve the excess profits tax or the meaning of "accumulated earnings and profits" as used in Section 718 (a) (4) of the Code, but rather the question whether uncollected and unreported

---

porting upon the installment basis may not include in "accumulated earnings and profits" items of uncollected and unreported profits, and (2) that neither the wording nor the legislative history of Section 736 (a) warranted the conclusion that Congress intended an election under it to bring into accumulated earnings an item which prior thereto was not so includible. The Circuit Court of Appeals disagreed with the Tax Court only as to proposition (2). It reversed upon the ground that, since the taxpayer there reported upon the accrual basis for purposes of the excess profits tax, uncollected profits on installment sales were "recognized," as well as realized (p. 612)—"because they are taken into consideration in computing the part of the sales price to be included in the excess profit net income and subjected to the excess profits tax."

In short, by taking advantage of the option under Section 736 (a), the taxpayer in the *Kimbrell's* case was permitted to abandon the installment basis of accounting for excess profits tax purposes, but was also required to accrue its gains in the years the sales were made. Such gains, unlike the gains herein, were thus in fact *recognized* for excess profits tax purposes and were therefore included in the corporation's earnings and profits.

profits from installment sales might be included in "earnings and profits" available for the payment of dividends within the meaning of Section 115 (a) of the Revenue Act of 1936, c. 690, 49 Stat. 1648, which subsequently became Section 115 (a) of the Code. However, insofar as the question in the present case is concerned, neither the Tax Court, the Circuit Court of Appeals, the taxpayer, nor the Commissioner has suggested any difference in meaning between the term "accumulated earnings and profits" as used in Section 718 (a) (4) and the meaning of that term as used in Section 115 (a). The Treasury Regulations (Treasury Regulations 112, Section 35.718–2, Appendix, *infra,* p. 47) provide that in general the concept of "accumulated earnings and profits" for the purpose of the excess profits tax is the same as for the purpose of the income tax, and Section 728 of the Code (Appendix, *infra,* p. 44), as well as the legislative history of Section 115 (1) of the Code (Appendix, *infra,* p. 39), attest the correctness of that conclusion.[3]

[3] See Report of a Subcommittee of the House Committee on Ways and Means, 76th Cong., 3d Sess., p. 14, on "Proposed Excess-Profits Taxation and Special Amortization—1940" (G. P. O. 1940); H. Rep. No. 2894, 76th Cong., 3d Sess., pp. 41–43 (1940–2 Cum. Bull. 496, 526–527). See also subsections (a) (3), (5) and (7), (b) (1), (2), (3) and (5), and (c) (1), (3) and (5) of Section 718 of the Code, and H. Conference Rep. No. 3002, 76th Cong., 3d Sess., pp. 59–64 (1940–2 Cum. Bull. 548, 562–566), which confirm the conclusion that the term "earnings and profits" as used in Section 718 (a) (4) is employed in its tax sense.

771666—48——3

The decision of the present case, therefore, does not turn upon any peculiarities of the excess profits tax provisions, but is controlled by principles applicable in determining "earnings and profits" in the federal tax sense, as those principles are laid down in the applicable Treasury Regulations, namely, Sections 29.115–3 and 29.115–12 of Regulations 111 (Appendix, *infra*, pp. 44–47).

The ultimate question in the case therefore is as to the validity of these Regulations.

A. THE PERTINENT REGULATIONS SPECIFICALLY COVER THIS CASE

Section 29.115–3 of Regulations 111 (Appendix, *infra*, pp. 44–45, provides as follows:

> SEC. 29.115–3. *Earnings or Profits.*—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and, while mere bookkeeping entries increasing or decreasing surplus will not be conclusive, the amount of the earnings or profits in any case will be dependent upon the method of accounting properly employed in computing net income. For instance, a corporation keeping its books and filing its income tax returns under sections 41, 42, and 43 on the cash receipts and disbursements basis may not use the accrual basis in determining earnings and

profits; *a corporation computing income on the installment basis as provided in section 44 shall, with respect to the installment transactions, compute earnings and profits on such basis;* and an insurance company subject to taxation under section 204 shall exclude from earnings and profits that portion of any premium which is unearned under the provisions of section 204 (b) (3) and which is segregated accordingly in the unearned premium reserve.

Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22 (a) or corresponding provisions of prior Revenue Acts. *Gains and losses within the purview of section 112 or corresponding provisions of prior Revenue Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section (see section 29.115–12).*

* * * [Italics supplied.]

The provision of the above-quoted Regulations, that a corporation computing income on the installment basis as provided in Section 44 shall with respect to the installment transactions compute earnings and profits on such basis, specifically covers this case. These Regulations by their express terms are applicable in determining "the amount of the earnings or profits in any case."

They are, therefore, not limited to the determination of earnings and profits for a given year, or for any specific period, as contended by the taxpayer in its Brief in Opposition, p. 13. The cross-reference to these Regulations contained in Section 35.718–2 of Regulations 112 (Appendix, *infra*, p. 47), relating exclusively to the excess profits tax, leaves no doubt that these Regulations were intended to be applied in determining "accumulated earnings and profits" under Section 718 (a) (4). This is further confirmed by the provisions of Section 29.115–12 of Regulations 111, dealing with the application of Section 115 (l) of the Code relating to the effect on earnings and profits of gain or loss realized after February 28, 1913.[4] It was stipulated (R. 26) that

[4] Section 29.115–12 states that the rules for determining gain or loss under Section 115 (l) of the Code "are applicable whenever under any provision of chapter 1 [containing the ordinary income tax provisions] or 2 [containing the excess profits tax provisions] it is necessary to compute either the total earnings and profits of the corporation or * * *." And the same section also describes the total earnings and profits of a corporation as being "of most frequent application in determining invested capital," which is relevant only for excess profits tax purposes.

Thus, these provisions make it clear that the method of determining earnings and profits for excess profits purposes is the same as for ordinary income tax purposes in Section 115 (l). Furthermore, Section 728 of the Code provides that "The terms used in this subchapter [i. e., the subchapter which imposes the excess profits tax] shall have the same meaning as when used in Chapter 1 [the chapter which imposes the ordinary income taxes and which contains such provisions as Section 115]." See Appendix, *infra*, p. 44.

the taxpayer computed income with respect to its installment sales on the installment basis, as provided by Section 44. Accordingly, under the provisions of these Regulations, the taxpayer's earnings and profits must be computed on that basis.[5]

B. THE PERTINENT REGULATIONS ARE VALID

The question whether Sections 29.115–3 and 29.115–12 of Regulations 111 are valid is narrowed to a determination whether they are so obviously an improper interpretation of the statute as to require that they be stricken down. The question is not whether the administrative determination is free from doubt, but whether it is a reasonable one. *Trust of Bingham* v. *Commissioner,* 325 U. S. 365; *Brewster* v. *Gage,* 280 U. S. 327; *Fawcus Machine Co.* v. *United States,* 282 U. S. 375. The decisions involving a comparable issue under the Revenue Act of 1918 to that here presented; the decision of this Court in *Commissioner* v. *Wheeler,* 324 U. S. 542; the development of the installment basis as a separate method of returning gain from installment sales; the decisions requiring that the same method of computing and reporting gains for income tax purposes

[5] It is, of course, irrelevant that the taxpayer keeps its books and makes its return of other income upon the accrual basis, and as a bookkeeping matter accrues the gain from installment sales in the year in which they are made. Moreover, the taxpayer has not contended that the fact that it accrued the unreported profits from its installment sales on its books has any bearing on the question here presented.

be followed in determining earnings and profits; the provisions and legislative history of Section 115 (l) of the Code; and the provisions of Sections 111 and 112 of the Code—all support the validity of the Regulations.

1. *The decisions under the excess profits tax provisions of the Revenue Act of 1918*

As indicated above (p. 17), a similar issue arose on numerous occasions under Section 326 (a) (3) of the Revenue Act of 1918 (c. 18, 40 Stat. 1057) with respect to the war-profits and excess-profits tax then in effect. That provision read as follows:

> SEC. 326. (a) That as used in this title the term "invested capital" for any year means (except as provided in subdivisions (b) and (c) of this section):
>
> * * * * *
>
> (3) Paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during the year;
>
> * * *

Although the language of this section is not identical with Section 718 (a) (4) of the Code, here involved, the provisions of both sections in effect require the inclusion of accumulated earnings and profits in invested capital, and under the 1918 Act, it was uniformly held that uncollected gains on installment sales in the case of taxpayers reporting on the installment basis were not to be included in earnings of the taxpayer for the pur-

pose of determining its invested capital. See e. g., *Schmoller & Mueller Piano Co.* v. *United States*, 67 C. Cls. 428; *John M. Brant Co.* v. *United States*, 40 F. 2d 126 (C. Cls.), certiorari denied, 282 U. S. 888; *Standard Computing Scale Co.* v. *United States*, 52 F. 2d 1018 (C. Cls.); *Jacob Bros. Co.* v. *Commissioner*, 50 F. 2d 394 (C. C. A. 2d); *Tull & Gibbs* v. *United States*, 48 F. 2d 148 (C. C. A. 9th). The decisions of the Board of Tax Appeals are to the same effect. See e. g., *Blum's Inc.* v. *Commissioner*, 7 B. T. A. 737, 771; *S. Davidson & Bros.* v. *Commissioner*, 21 B. T. A. 638, 644; also *Federal St. & Pleasant Valley Passenger Ry. Co.* v. *Commissioner*, 24 B. T. A. 262, 266.

Thus, at the outset, there appears ample historical justification for an application of this principle to the excess profits tax provisions of the Code.

2. *The decision of this Court in* Commissioner *v.* Wheeler *supports the validity of these Regulations*

The last sentence (italicized) of Section 29.115–3 of Regulation 111 quoted above, supra, p. 15, is as it appeared in Article 115–3 of Regulations 101, defining earnings and profits which was considered and approved by this Court in the case of *Commissioner* v. *Wheeler*, 324 U. S. 542. This portion of the Regulations provides for both the time when and the extent to which such gains and

losses shall be brought into the earnings and profits. While the *Wheeler* case involved the basis for determining earnings and profits of securities in the hands of a corporation acquired by it in a non-taxable exchange, that question had implicit in it both the extent to which and the time when gains from a transaction are to be brought into earnings and profits. The Court held the Regulations to be valid and based its decision thereon. It is true that the portion of the Regulations (Section 29.115–3) which provides that the amount of the earnings and profits in any case will be dependent upon the method of accounting properly employed in computing net income and the portion thereof which provides that a corporation computing income on the installment basis, as provided in Section 44, shall, with respect to the installment transactions, compute earnings and profits on such basis, were not contained in the Regulations approved by this Court in that case. Nevertheless, the same principles which led the Court to uphold the validity of the portion of the Regulations there involved require that the additional portions of Regulations here in question be sustained.*

In the *Wheeler* case, the Court held that the same policy which carried over the transferor's

*These provisions of Section 29.115–3 involving the method of return in the computation of earnings and profits were added by way of an amendment to Section 19.115–3 of Regulations 103, in T. D. 5059, 1941–2 Cum. Bull. 125.

basis for purposes of the corporation's income tax required carrying it over for determining the corporation's earnings and profits. The holding of the Court thus correlates not only the extent to which, but the time when, gain shall be brought into earnings and profits with the extent to which and the time when such gain shall enter into the computation of net income. It would seem necessarily to follow that the same correlation is required in the method employed in computing net income and earnings and profits on any basis of accounting recognized for purposes of taxation.

3. *The installment basis of return of gain from sales of property is a separate and independent statutory method of return*

Prior to the Revenue Act of 1926, c. 27, 44 Stat. 9, there was no express provision for the installment method of return. However, such method had been provided for prior thereto by the Regulations, originally by Article 117 of Regulations 33 (Revised), promulgated January 2, 1918, and this was followed by Article 42 of Regulations 45, promulgated April 17, 1919. These Regulations, particularly Article 42 of Regulations 45, not only established and defined the "installment basis" of return, but provided for that basis as an additional one to the cash and accrual methods of making returns. Thus these Regulations did not prohibit such return to be made upon either of the other two bases.

These Regulations were, however, in the absence of supporting legislation, held invalid in 1925 by the Board of Tax Appeals in a series of cases,[1] and in response thereto Congress enacted Section 212 (d) of the 1926 Act, now subsections (a) and (b) of Section 44 of the Code. It is to be noted that Congress regarded such basis of return as having already received its implied approval in Section 202 (f) of the Revenue Act of 1921, c. 136, 42 Stat. 227, which is now Section 111 (d) of the Code, and, moreover, that it regarded such method as contributing a *third* basis of return. Thus, it was stated in S. Rep. No. 52, 69th Cong., 1st Sess., p. 19 (1939–1 Cum. Bull. (Part 2) 332, 346):

> SECTION 212 (d). The revenue act of 1924 and prior acts have specifically provided two bases only for reporting income—first, cash receipts and disbursements, and, second, accrual. Since the enactment of the revenue act of 1921, however, *Section 202 (f) and its successors have impliedly recognized the existence of a third basis, the installment basis,* without in any wise defining the situations and businesses to which such basis might be applied. The Commissioner of Internal Revenue has in his regu-

[1] See particularly *Todd* v. *Commissioner*, 1 B. T. A. 762; also *H. B. Graves Co.* v. *Commissioner*, 1 B. T. A. 859; *Hoover-Bond Co.* v. *Commissioner*, 1 B. T. A. 929; *Six Hundred and Fifty West End Avenue Co.* v. *Commissioner*, 2 B. T. A. 958.

lations provided, in pursuance of his authority to require a method of computation that will clearly reflect income, the installment basis for reporting income in certain cases.[8] [Italics supplied.]

The decisions under the Revenue Act of 1918, *supra*, p. 19, support the view that the installment basis of accounting, thus expressly recognized by law, constituted a third basis of return and was a separate and independent method of accounting and one that is coequal with the cash and accrual bases (now provided for by Sections 41 to 43 of the Code (Appendix, *infra*, pp. 34–35)), insofar as it permits the return of gains from installment sales pursuant thereto.

4. *It is an established principle that the same method employed in computing and reporting gains for income tax purposes must be used in determining earnings and profits*

Even prior to the decision of this Court in the *Wheeler* case, it was an established principle that the same method employed in computing and reporting gains for income tax purposes must be used in determining earnings and profits. See G. C. M. 2951, VII–1 Cum. Bull. 160 (1928); I. T. 3253, 1939–1 Cum. Bull. 178; *Helvering* v. *Alworth*

[8] For an exhaustive review of the history of the taxation of installment sales, see *Blum's, Inc.* v. *Commissioner*, 7 B. T. A. 737, 751 *et seq.*; as also *Willcuts* v. *Gradwohl*, 58 F. 2d 587, 590 *et seq.* (C. C. A. 8th).

Trust, 136 F. 2d 812 (C. C. A. 8th), certiorari denied, 320 U. S. 784; *Siegel* v. *Commissioner*, 29 B. T. A. 1289, 1293; *Neptune Meter Co.* v. *Price*, 98 F. 2d 76 (C. C. A. 2d); *Wells Fargo Bank & Union Trust Co.* v. *McLaughlin*, 78 F. 2d 934 (C. C. A. 9th), certiorari denied, 296 U. S. 638.

In the *Alworth Trust* case, *supra*, it was held that earnings and profits in the taxable year of a taxpayer upon the cash basis were not diminished by the amount of federal taxes which had not been paid or accrued by the corporation in that year, even though imposed upon the earnings for that year.[9] Cf. *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359, 366. The decisions under the Revenue Act of 1918, *supra*, p. 19, rest upon the principle that the same method was required to be used in the case of taxpayers on the installment basis of return in computing earnings and profits as was used in computing net income. Thus, in *Jacob Bros. Co.* v. *Commissioner*, *supra*, (50 F. 2d, p. 396) the Second Circuit said that the installment basis of return was in effect accounting on the cash basis (though, of course, not the conventional one) for both the purposes of computing net income and for that of computing earnings and profits.

[9] See Rudick, *"Dividends" and "Earnings or Profits" under the Income Tax Law: Corporate Nonliquidating Distributions*, 89 U. Pa. L. Rev. 865, 878-879 (1941).

5. *Section 115 (l) of the Code justifies the provisions of Section 29.115–3 of Regulations 111*

Section 115 (l) of the Code (added by Section 501 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974), after describing the method of determining gain or loss from the sale of property by a corporation, for the purpose of computing its "earnings and profits," explicitly provides:

> Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made.

In explanation of the amendment which added subsection (l) to Section 115, the Ways and Means Committee of the House made the following statement in its report, H. Rep. No. 2894, 76th Cong., 3d Sess., p. 41 (1940–2 Cum. Bull. 496, 526):

> SECTION 401 [501] EARNINGS AND PROFITS OF CORPORATIONS
>
> The purpose of this amendment is to clarify the law with respect to what constitutes earnings and profits of a corporation. This is important not only for the purpose of determining whether distributions are taxable dividends but also

in determining equity invested capital for excess-profits-tax purposes.

Section 401 of the bill inserts subsection (l) in section 115 of the Internal Revenue Code and correspondingly amends prior revenue acts. The rule, applied by the Treasury under existing law, is that while gains or losses which are not recognized by reason of the provisions of section 112 neither increase nor diminish the earnings or profits, the earnings or profits are increased or diminished by the entire amount of the recognized gain or loss, computed in accordance with the provisions of sections 111, 112, and 113. Together with the provisions of section 115 (h) of the Internal Revenue Code, and the principles established in *Commissioner* v. *Sansome*, 60 F. 2d 931, and following decisions, the rule effectuates the provisions of section 112. While taxpayers generally have concurred in the rule applied by the Treasury, the Board of Tax Appeals and some of the courts have not agreed but have followed the theory that gain or loss, *even though not recognized in computing net income*, nevertheless affects earnings and profits.[10] * * * [Italics supplied.]

---

[10] As explicitly appears from this report (p. 42), one of the purposes of the amendment was to overrule the principle applied in the case of *Commissioner* v. *F. J. Young Corp.*, 103 F. 2d 137 (C. C. A. 3d), and similar holdings. But it was upon the theory of that line of cases that the decision of the court in the *Shenandoah Co.* case (*supra*, p. 12) was rested, at least in part. See also the unreported decision of the Tax

Thus, the language of Section 115 (l) as explained in the foregoing report clearly evidences a Congressional purpose to provide that, until gain is recognized in the computation of net income, it will not affect earnings and profits. As stated in the report, earnings and profits are increased or diminished only by the amount of the recognized gain or loss, computed in accordance with Sections 111, 112 and 113.

It is true that Section 115 (l) refers to the gain or loss recognized in computing net income "under the law applicable to the year in which such sale or disposition was made," and the taxpayer argued in its brief in opposition (pp. 3–4, 9) that this language means that, unless the gain is recognized in the year of sale, it cannot enter into the computation of earnings and profits.

The error in this contention lies in the fact that the foregoing provision merely fixes the law in effect during the year of sale as being controlling in the determination of earnings and profits. It does not require that the gain be brought into

---

Court in that case, 1943 P–H T. C. Memorandum Decisions, par. 43,028, promulgated January 16, 1943. At the time of the Tax Court's decision in the *Shenandoah Co.* case, Section 115 (l) had been added to the Code, but was apparently overlooked by the judge who decided the case. On the other hand, within thirty days after the decision in the *Shenandoah* case, another judge of the Tax Court in deciding the case of *Wheeler* v. *Commissioner*, 1 T. C. 640, held that the *Young* and the other cases involving similar holdings had been overruled by Congress in its enactment of Section 115 (l).

earnings and profits in such year. And indeed, the law in effect in the year of sale may require that the gain be brought into earnings and profits in some other year. This is made clear by Section 29.115–12 of Regulations 111, which provides:

> As used in this subsection the term "recognized" has reference to that kind of realized gain or loss which is recognized for income tax purposes by the statute applicable to the year in which the gain or loss was realized, for example, see section 112. * * *

Thus, the provisions of Sections 44 and 111, as well as 112, all of which constitute parts of a comprehensive and interrelated system, are brought into play here.

Section 112 (a) announces the general rule as to *recognition* of gain or loss upon the sale or exchange of property, and it refers to Section 111 for the purpose of determining the amount of gain or loss. Section 111 (a) and (b) establish the general rule for computing the gain or loss, Section 111 (c) makes a general cross reference to Section 112 as to recognition, and, finally, Section 111 (d) deals specifically with installment sales. Section 111 (d) provides that nothing in Section 111 shall be construed to prevent, in the case of installment sales (that is, sales under Section 44):

> the taxation of that portion of any installment payment representing gain or profit

in the year in which such payment is received.

In the first place, the word "taxation" is no doubt the broadest one which could have been used in this connection. For it contemplates not only the impostion of the tax, but every step necessary thereto, including the computation of net income.

In the second place, the word "taxation" as used in Section 111 (d) refers to "that portion of any installment payment representing gain or profit in the year in which such payment is received." This language clearly indicates that each installment payment embraces a portion of the total gain or profit to be derived from the sale and that such gain or profit is derived in the year in which such payment is received, not necessarily in the year the sale is completed. This accords with the Section 44 concept of return. Accordingly, Section 111 (d) clearly requires the recognition of gain from installment sales to be determined for all purposes in accordance with the method provided for in Section 44 (a).

Moreover, it is apparent that Sections 111 and 112 are superimposed upon the general provisions of Sections 41 to 44, inclusive, relating to the various methods of reporting income. Thus, subsection (a) of Section 111 provides that the gain from the sale or the disposition of property shall be the excess of the "amount realized" over

the adjusted basis provided in Section 113 (b) for determining gain, and subsection (b) of Section 111 provides that the "amount realized" from such sales shall be the sum of money received plus the fair market value of other property received. And, as stated, Section 112 (a) provides that upon the sale or exchange of property the entire amount of the gain or loss, determined under Section 111, shall be recognized, except as otherwise provided in the other subsections of Section 112. Thus, there is no express provision in these sections dealing with the time element for taking gain either into net income or into earnings and profits.

It is obvious, therefore, in the scheme of the statute, that the basic accounting provisions in Sections 41–44 underlie the provisions of Sections 111 and 112 for the purpose of fixing the time when the gains computed and recognized under Sections 111 and 112 shall be taken into account. For example, while Section 111 (b) defines "amount realized" as the sum of money and the fair market value of other property received, nevertheless, the entire gain from a sale derived by a taxpayer employing the accrual method of accounting would be reported in the year of sale without regard to the time when the money or other property is received. On the other hand, a taxpayer on the cash basis would report gain only in the year in which cash or other property

having a fair market value was actually received by it. The installment method of reporting, while not conforming exactly to the conventional cash method, has in common therewith that feature which requires the gain to be reckoned as of the time of receipt of cash. The installment method is unlike the cash method in that it disregards the receipt of the installment obligations themselves notwithstanding the fact that the installment obligations received, if any, may have a fair market value. Indeed, one of the purposes of establishing the installment basis of return for tax purposes was to avoid the necessity of valuing such obligations. See S. Rep. No. 52, 69th Cong., 1st Sess., p. 19 (1939–1 Cum. Bull. (Part 2) 332, 347) already referred to (*supra*, p. 22), as also *Blum's Inc.* v. *Commissioner, supra* (7 B. T. A. at pp. 741, 757, 771) and *Willcuts* v. *Gradwohl, supra* (58 F. 2d at pp. 589–590).[11]

[11] In the court below the taxpayer cited *Lawler* v. *Commissioner*, 78 F. 2d 567 (C. C. A. 9th); *Provident Trust Co.* v. *Commissioner*, 76 F. 2d 810 (C. C. A. 3d); *Crane* v. *Helvering*, 76 F. 2d 99 (C. C. A. 2d), and *Nuckolls* v. *United States*, 76 F. 2d 357 (C. C. A. 10th), as holding that "realization" of gain from installment sales occurs in the year of sale. Those cases involved no question comparable to that here presented. There the question was with respect to the application and constitutional validity of subsection (d) of Section 44. That subsection provides that, if an installment obligation is transmitted, sold or otherwise disposed of, gain or loss shall result to the extent of the difference between the basis of the obligation and its fair market value at the time of such distri-

In the court below the taxpayer emphasized the fact that there are certain instances where items are taken into account for purposes of determining earnings and profits which are not taken into account for the purpose of net income. And from this the taxpayer argued that the time element was not a relevant factor in the determination of earnings and profits. The Commissioner, of course, does not contend that "earnings and profits" conform exactly to taxable income. His Regulations (Section 29.115–3 of Regulations 111) set forth instances where there is a difference in treatment of items for the two purposes; and this Court in the *Wheeler* case (324 U. S. at 546) also adverted to this absence of exact conformity between the determination of earnings and profits and the determination of taxable income. See also H. Rep. No. 2894, 76th Cong., 3d Sess., p. 41 (1940–2 Cum. Bull. 496, 526–527); S. Rep. No. 2114, 76th Cong., 3d Sess., pp. 22–27 (1940–2 Cum. Bull. 528, 545–548), and H. Conference Rep. No. 3002, 76th Cong., 3d Sess., pp. 59–62 (1940–2 Cum. Bull. 548, 562–564).

---

bution, transmission or disposition. It was held in those cases that there was no constitutional obstacle to the taxation of the gain so computed at the time of the sale or other disposition of the installment obligation. Those cases, rather than supporting the taxpayer's position here, support the view that neither realization nor recognition of the entire gain from the sale of the original property took place in the year of the sale of such original property but took place instead, at least in part, in the year in which the installment obligations were sold or otherwise disposed of.

However, in this case, there is no question that such gain as may be realized from the installment sales is of a character that is to be taken into account for both net income and earnings and profits purposes. As stated, the substantial controversy relates to the time when such gain is to be taken into account for earnings and profits purposes. We submit that the Tax Court properly held that the time when the gain in question should be brought into earnings and profits must coincide with the time it is brought into net income.

CONCLUSION

For the reasons stated, the decision of the court below should be reversed.

Respectfully submitted.

PHILIP B. PERLMAN,
Solicitor General.
THERON LAMAR CAUDLE,
Assistant Attorney General.
ARNOLD RAUM,
GEORGE A. STINSON,
LEE A. JACKSON,
CARLTON FOX,
Special Assistants to the Attorney General.

JANUARY 1948.

APPENDIX

Internal Revenue Code:

Chapter 1—Income Tax

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

(26 U. S. C. 1940 ed., Sec. 41.)

SEC. 42 [As amended by Section 114 of the Revenue Act of 1941, c. 412, 55 Stat. 687, and as further amended by Section 134 of the Revenue Act of 1942, c. 619, 56 Stat. 798]. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.—

(a) *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless,

under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. In the case of the death of a taxpayer whose net income is computed upon the basis of the accrual method of accounting, amounts (except amounts includible in computing a partner's net income under section 182) accrued only by reason of the death of the taxpayer shall not be included in computing net income for the period in which falls the date of the taxpayer's death.

* * * * *

(26 U. S. C. 1940 ed., Sec. 42.)

SEC. 43 [As amended by Sec. 134 (b) of the Revenue Act of 1942, *supra*]. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. In the case of the death of a taxpayer whose net income is computed upon the basis of the accrual method of accounting, amounts (except amounts includible in computing a partner's net income under section 182) accrued as deductions and credits only by reason of the death of the taxpayer shall not be allowed in computing net income for the period in which falls the date of the taxpayer's death.

(26 U. S. C. 1940 ed., Sec. 43.)

SEC. 44. INSTALLMENT BASIS.

(a) *Dealers in Personal Property.*—Under regulations prescribed by the Commissioner with the approval of the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed, bears to the total contract price.

(b) *Sales of Realty and Casual Sales of Personality* [*sic*].—In the case (1) of a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year), for a price exceeding $1,000, or (2) of a sale or other disposition of real property, if in either case the initial payments do not exceed 30 per centum of the selling price (or, in case the sale or other disposition was in a taxable year beginning prior to January 1, 1934, the percentage of the selling price prescribed in the law applicable to such year), the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the basis and in the manner above prescribed in this section. As used in this section the term "initial payments" means the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made.

* * * * *

(26 U. S. C. 1940 ed., Sec. 44.)

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount Realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

(c) *Recognition of Gain or Loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this chapter, shall be determined under the provisions of section 112.

(d) *Installment Sales.*—Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received. (26 U. S. C. 1940 ed., Sec. 111.)

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

* * * * * *

(26 U. S. C. 1940 ed., Sec. 112.)

SEC. 115. DISTRIBUTION BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

* * * * * *

(h) *Effect on Earnings and Profits of Distributions of Stock.*—The distribution (whether before January 1, 1939, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities, of stock or securities in another corporation, or of property or money, shall not be considered a distribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities, property or money, was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934, 48 Stat. 712, or a corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock

or securities" includes rights to acquire stock or securities.

* * * * *

(l) [As added by Section 501 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974, 1004] *Effect on Earnings and Profits of Gain or Loss and of Receipt of Tax-Free Distributions.*—The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

(1) for the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made.

* * * * *

(26 U. S. C. 1940 ed., Sec. 115.)

Chapter 2—Additional Income Taxes

SUBCHAPTER A—PERSONAL HOLDING COMPANIES

* * * * *

SUBCHAPTER B [as amended by Section 506 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974]—DECLARED VALUE EXCESS PROFITS TAX.

* * * * *

SUBCHAPTER C—EXCESS PROFITS ON NAVY CONTRACTS

* * * * *

SUBCHAPTER D—UNJUST ENRICHMENT

* * * * *

SUBCHAPTER E—EXCESS PROFITS TAX [as added by Section 201 of the Second Revenue Act of 1940, *supra,* which provided that the new subchapter may be cited as the "Excess Profits Tax Act of 1940"].

PART I

SEC. 710. IMPOSITION OF TAX.

(a) *Imposition.*—

(1) [as amended by Section 202 of the Revenue Act of 1942, c. 619, 56 Stat. 798] *General Rule.*—There shall be levied, collected, and paid, for each taxable year, upon the adjusted excess profits net income, as defined in subsection (b), of every corporation (except a corporation exempt under section 727) a tax equal to whichever of the following amounts is the lesser:

(A) 90 per centum of the adjusted excess profits net income, or

* * * * *

(b) *Definition of Adjusted Excess Profits Net Income.*—As used in this section, the term "adjusted excess profits net income"

in the case of any taxable year means the excess profits net income (as defined in Section 711) minus the sum of:

(1) [as amended by Section 205 of the Revenue Act of 1942, *supra*] *Specific Exemption.*—A specific exemption of $5,000, and in the case of a mutual insurance company (other than life or marine) which is an interinsurer or reciprocal underwriter a specific exemption of $50,000;

(2) *Excess Profits Credit.*—The amount of the excess profits credit allowed under Section 712; and

(3) [As amended by Sec. 2 (a) of the Excess Profits Tax Amendments of 1941, c. 10, 55 Stat. 17, and Sec. 204 (a) of the Revenue Act of 1942, *supra*] *Unused Excess Profits Credit.*—The amount of the unused excess profits credit adjustment for the taxable year, computed in accordance with subsection (c).

* * * * *

(26 U. S. C. 1940 ed., Sec. 710.)

SEC. 711. EXCESS PROFITS NET INCOME.

(a) *Taxable Years beginning After December 31, 1939.*—The excess profits net income for any taxable year beginning after December 31, 1939, shall be the normal-tax net income, as defined in section 13 (a) (2), for such year except that the following adjustments shall be made:

* * * * *

(2) *Excess Profits Credit Computed Under Invested Capital Credit.*—If the excess profits credit is computed under section 714, the adjustments shall be as follows:

* * * * *

(26 U. S. C. 1940 ed., Sec. 711.)

SEC. 712 [as amended by Section 13 of the Act of March 7, 1941, c. 10, 55 Stat. 17]. EXCESS PROFITS CREDIT-ALLOWANCE.

(a) *Domestic Corporations.*—In the case of a domestic corporation which was in existence before January 1, 1940, the excess profits credit for any taxable year shall be an amount computed under section 713 or section 714, whichever amount results in the lesser tax under this subchapter for the taxable year for which the tax under this subchapter is being computed. In the case of all other domestic corporations the excess profits credit for any taxable year shall be an amount computed under section 714.

* * * * *

(26 U. S. C. 1940 ed., Sec. 712.)

SEC. 714 [As amended by Section 217, Revenue Act of 1942, *supra*]. EXCESS PROFITS CREDIT—BASED ON INVESTED CAPITAL.

The excess profits credit, for any taxable year, computed under this section, shall be the amount shown in the following table:

If the invested capital for the taxable year, determined under section 715, is not over $5,000,000, the credit shall be 8% of the invested capital.

* * * * *

(26 U. S. C. 1940 ed., Sec. 714.)

SEC. 715. DEFINITION OF INVESTED CAPITAL.

For the purposes of this subchapter the invested capital for any taxable year shall be the average invested capital for such year, determined under section 716, reduced by an amount computed under section 720 (relating to inadmissible assets). If the Commissioner finds that in any case the determination of invested capital, on a basis other than a daily basis,

will produce an invested capital differing by not more than $1,000 from an invested capital determined on a daily basis, he may, under regulations prescribed by him with the approval of the Secretary, provide for such determination on such other basis. (For computation of invested capital in case of foreign corporations and corporations entitled to the benefits of section 251, see section 724.)

(26 U. S. C. 1940, ed., Sec. 715.)

SEC. 716. AVERAGE INVESTED CAPITAL.

The average invested capital for any taxable year, shall be the aggregate of the daily invested capital for each day of such taxable year, divided by the number of days in such taxable year.

(26 U. S. C. 1940 ed., Sec. 716.)

SEC. 717. DAILY INVESTED CAPITAL.

The daily invested capital for any day of the taxable year shall be the sum of the equity invested capital for such day plus the borrowed invested capital for such day determined under section 719.

(26 U. S. C. 1940 ed., Sec. 717.)

SEC. 718. EQUITY INVESTED CAPITAL.

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

* * * * *

(4) *Earnings and Profits at Beginning of Year.*—The accumulated earnings and profits as of the beginning of such taxable year;

* * * * *

(26 U. S. C. 1940 ed., Sec. 718.)

SEC. 728. MEANING OF TERMS USED.

The terms used in this subchapter shall have the same meaning as when used in Chapter 1.

(26 U. S. C. 1940 ed., Sec. 728.)

Second Revenue Act of 1940, c. 757, 54 Stat. 974:

SEC. 501. EARNINGS AND PROFITS OF CORPORATIONS.

* * * * *

(c) *Under Prior Acts.*—For the purposes of the Revenue Act of 1938 or any prior Revenue Act the amendments made to the Internal Revenue Code by subsection (a) of this section shall be effective as if they were a part of each such Revenue Act on the date of its enactment. Nothing in this subsection shall affect the tax liability of any taxpayer for any year which, on September 20, 1940, was pending before, or was theretofore determined by, the Board of Tax Appeals, or any court of the United States.

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.115–3. *Earnings or Profits.*—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and, while mere bookkeeping entries increasing or decreasing surplus will not be conclusive, the amount of the earnings or profits in any case will be dependent upon the method of accounting properly employed in computing net income. For instance, a corporation keeping its books

and filing its income tax returns under sections 41, 42, and 43 on the cash receipts and disbursements basis may not use the accrual basis in determining earnings and profits; a corporation computing income on the installment basis as provided in section 44 shall, with respect to the installment transactions, compute earnings and profits on such basis; and an insurance company subject to taxation under section 204 shall exclude from earnings and profits that portion of any premium which is unearned under the provisions of section 204 (b) (5) and which is segregated accordingly in the unearned premium reserve.

* * * Gains and losses within the purview of section 112 or corresponding provisions of prior Revenue Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section (see section 29.115–12). * * *

* * * * * *

SEC. 29. 115–12. *Effect on Earnings and Profits of Gain or Loss Realized After February 28, 1913.*—In order to determine the effect on earnings and profits of gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation, section 115 (l) prescribed certain rules for (1) the computation of the total earnings and profits of the corporation, of most frequent application in determining invested capital; and (2) the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, of most frequent application in determining the source of dividend distributions. Such rules are ap-

plicable whenever under any provision of chapter 1 or 2 it is necessary to compute either the total earnings and profits of the corporation or the earnings and profits for any period beginning after February 28, 1913. * * *

The gain or loss so realized increases or decreases the earnings and profits to, but not beyond, the extent to which such gain or loss was *recognized* in computing net income under the law applicable to the year in which such sale or disposition was made. As used in this subsection the term "recognized" has reference to that kind of realized gain or loss which is recognized for income tax purposes by the statute applicable to the year in which the gain or loss was realized, for example, see section 112. A loss (other than a wash sale loss with respect to which a deduction is disallowed under the provisions of section 118 or corresponding provisions of prior revenue laws) may be recognized though not allowed as a deduction (by reason, for example, of the operation of sections 24 (b) and 117 and corresponding provisions of prior revenue laws) but the mere fact that it is not allowed does not prevent decrease in earnings and profits by the amount of such disallowed loss. Wash sale losses, however, disallowed under section 118 and corresponding provisions of prior revenue laws, are deemed nonrecognized losses and do not reduce earnings or profits. The "recognized" gain or loss for the purpose of computing earnings and profits is determined by applying the recognition provisions to the realized gain or loss computed under the provisions of section 115 (l) as distinguished from the realized gain or loss used in computing net income. The application

of this paragraph may be illustrated by the following examples: * * *

* * * * * *

Treasury Regulations 112, promulgated under the Internal Revenue Code:

SEC. 35.718–2. *Determination of Daily Equity Invested Capital—Accumulated Earnings and Profits.*—(a) *In general.*—The term "accumulated earnings and profits" is not defined in the Internal Revenue Code. See, however, section 115 and the regulations prescribed thereunder as to the effect of certain transactions on earnings and profits, and section 35.718–5 as to the effect of the declaration and distribution of dividends. In general, the concept of "accumulated earnings and profits" for the purpose of the excess profits tax is the same as for the purpose of the income tax.[1] * * *

SEC. 35.718–6. *Determination of Daily Equity Invested Capital—Reduction by Earnings and Profits of Another Corporation.*—Section 718 (b) (3) provides for the elimination of the duplication which occurs in the computation of the equity invested capital of the taxpayer following a transaction of the character referred to therein, as a result of which the earnings and profits of another corporation became the earnings and profits of the taxpayer.[2] The earnings and profits of such other corporation having been included at the time of the trans-

[1] Substantially the same provision appeared in Section 30.718–2 of Treasury Regulations 109, promulgated in 1941 under the Internal Revenue Code as amended by the Second Revenue Act of 1940.

[2] *Commissioner* v. *Sansome*, 60 Fed. (2d) 931.

action in the earnings and profits of the taxpayer, they remain continuously thereafter a part of such earnings and profits account for the purpose of computing for any day after such transaction the earnings and profits, the accumulated earnings and profits at the beginning of the taxable year, and the earnings and profits of the taxable year. In addition, however, the amount of such included earnings and profits is also brought into computation of equity invested capital of the taxpayer under provisions of section 718 other than section 718 (a) (4) relating to accumulated earnings and profits as of the beginning of the taxable year. * * *

* * * * * *

U. S. GOVERNMENT PRINTING OFFICE: 1948

IN THE

Supreme Court of the United States

OCTOBER TERM—1947

No. 384

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

SOUTH TEXAS LUMBER COMPANY,
Respondent.

RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI.

J. ARTHUR PLATT,
Attorney for Respondent,
20th Floor, Sterling Building,
Houston, Texas.

INDEX

Table of Citations

Cases

Statutes

Treasury Regulations

Opinions Below

The opinion of the Tax Court is reported in 7 T. C. 669 (August 30, 1946). The opinions of the Circuit Court of Appeals are reported in 162 F. (2d) 866 (July 3, 1947).

IN THE

Supreme Court of the United States

OCTOBER TERM—1947

No. 384

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

SOUTH TEXAS LUMBER COMPANY,
Respondent.

RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

The writ should be denied because:

1. The decision below is not in conflict with the decision of any other Circuit Court but, on the contrary, cites and follows the only other cases in the Circuit Courts that have considered the question presented, to wit: the determination of the earnings and profits of an installment seller under §115(l) I. R. C.

2. The reasons urged by the Government for granting the writ are without substance.

Preliminary Statement.

The taxpayer sold real estate on the installment basis, receiving in payment therefor cash and promissory notes secured by a lien on the land. The taxpayer, being on the

accrual basis, carried on its books as receivables the installment obligations received from such sales (R. 31). Income from the sales was reported for income tax and excess profits tax purposes under the installment provisions contained in §44(a) I. R. C. (R. 31). The question is whether, in determining the taxpayer's earnings and profits as of the beginning of a taxable year, the profit from installment sales made in prior years is includible in full in such earnings and profits. The question arises in connection with the determination of the taxpayer's invested capital credit under the excess profits tax. The deficiency in controversy is $1,708.53 (R. 30).

If the taxpayer had not elected to report the gains from such sales on the installment basis, the full amount of such gains would have been taxable in the years the sales were made (Reg. 111, §§29.44-3, 29,44-4) and, as the court below pointed out (R. 53), the Commissioner would then concede that the profits from such sales were fully includible in the taxpayer's earnings and profits at the dates involved even though a part of such gains remained to be collected. There is, therefore, no objection to the includibility of such profits on the ground that they had not been collected, *i.e.*, that they were represented by installment obligations payable in the future.

The sole question is, therefore, whether the uncollected profits from the installment sales, represented by installment obligations on hand at the dates involved, should be excluded from taxpayer's earnings and profits because taxpayer, having availed itself of the privilege of reporting such profits on the installment basis, had not previously paid a tax thereon. The court below held not. In so holding the court below (by a majority consisting of Sibley and Waller, JJ.) followed its own prior decision (rendered by a majority consisting of Hutcheson and Russell, JJ.) in *Comm'r* v. *Shenandoah Company*, 138 F. (2d) 792 (1943).

Judge Holmes dissented in the present case and in the *Shenandoah* case.

The *Shenandoah* case is directly in point. It was squarely based on §115(l) of the Code, as the quotation at page 14 below shows. The petition for the writ agrees (pp. 8-11) that §115(l) is controlling on the question here presented. Section 115(l) (enacted by §501(a) of the Second Revenue Act of 1940) provides as follows:

> "EFFECT ON EARNINGS AND PROFITS OF GAIN OR LOSS AND OF RECEIPT OF TAX-FREE DISTRIBUTIONS.—The gain or loss realized *from the sale or other disposition* (after February 28, 1913) *of property* by a corporation—
>
> (1) for the purpose of the computation of earnings and profits of the corporation, *shall be determined*, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but
>
> (2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, *shall be determined* by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.
>
> Gain or loss so realized *shall* increase or decrease the earnings and profits *to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made.* • • •" (Italics added).

The Government contends, as it did in the *Shenandoah* case, that the part of the gain from installment sales which

has not previously been taxed is not includible in earnings and profits under the above provision on the theory that such part has not been "recognized in computing net income under the law applicable to the year in which such sale or disposition was made." This is the only specific assignment of error. (Of course, if this contention were correct, the gains in question would *never* be includible in the earnings and profits of the seller because recognition of such gains under the law of any year *other than the year of sale* would not meet the statutory test contained in §115(l).)

The sole argument advanced by the Government in the court below in support of its contention was that gains are not "recognized" until a tax is payable thereon. That argument is not expressly made in the petition for the writ, which merely begs the question throughout by *assuming* that recognition and taxation are synonymous terms. The Government's position is plainly unwarranted. The numerous differences between recognition and taxation are discussed in point 2(b) below (pp. 9-13).

Reasons for Denying Writ.

1. The decision below is not in conflict with the decision of any other Circuit Court but, on the contrary, cites and follows the only other cases in the Circuit Courts that have considered the question presented.

The Tax Court's decision in the present case (7 T. C. 669, August 30, 1946) was rested entirely upon the Tax Court's prior decision in *Kimbrell's Home Furnishings, Inc.*, 7 T. C. 339 (July 11, 1946) which was afterwards reversed by the Fourth Circuit Court of Appeals in a decision handed down on February 3, 1947. *Kimbrell's Home Furnishings, Inc.* v. *Comm'r*, 159 F. (2d) 608.

Apart from the decision of the Fourth Circuit in the *Kimbrell's* case, the only other decision which has considered the effect of §115(l) on the question here presented is the *Shenandoah* case, *supra* (138 F. (2d) 792), decided by the Fifth Circuit in 1943. The *Shenandoah* case was cited and followed by the Fourth Circuit in the *Kimbrell's* case, and the *Shenandoah* and *Kimbrell's* cases were cited and followed by the court below.

Neither the Tax Court's decision in the present case nor its decision in the Kimbrell's case contained any reference to §115(l) of the Code which, as conceded by the Government, is controlling on the question presented. Furthermore, in the only other case decided by the Tax Court on this issue, no reference was made to §115(l). *May, Stern & Co.*, 7 T. C. 1488 (memorandum opinion reported in 5 T. C. M. 806). That case, which was decided by the Tax Court subsequent to its decision in the present case, was also rested entirely on the authority of the Tax Court's prior decision in the *Kimbrell's* case, so far as the question here presented was involved.

After the reversal of the *Kimbrell's* case by the Fourth Circuit on February 3, 1947, the petitioner in the *May, Stern* case moved the Tax Court for reconsideration of its opinion in that case. By order dated March 25, 1947, the Tax Court granted the motion for reconsideration and directed briefs to be filed. In granting such motion the Tax Court noted that its decision in the *Kimbrell's* case had been reversed and that its previous decision in the *May, Stern* case had been rested solely on the authority of the *Kimbrell's* case. The *May, Stern* case has since been resubmitted to the Tax Court on briefs covering this issue and that court, which had not referred to §115(l) in any of its prior opinions on the subject, now has under consideration for the first time the question here presented, viz., the in-

cludibility in earnings and profits under §115(l) of profits from installment sales upon which no income or excess profits tax has been paid.*

The Commissioner did not ask this Court to review either the *Shenandoah* case or the *Kimbrell's* case. Since the court below merely followed those cases and since there have been no other or conflicting decisions rendered in the lower courts, the customary ground for certiorari is absent.

2. The reasons urged by the Government for granting the writ are without substance.

(a) The decision below is of relatively small importance in the orderly administration of the tax laws.

The petition urges that the decision below is of importance in the administration of the tax laws (1) because it "affects the excess profits tax liability of all corporations that reported income on the installment basis", and (2) because it would effect a change in the law with respect to the determination of earnings and profits for dividend purposes (Petition, p. 8). Neither contention is sound.

The decision below does not affect the excess profits tax liability "of all corporations that reported income on the installment basis".** In the first place, it could affect only installment sellers who computed their excess profits tax by use of the invested capital credit. Many installment sellers used the income credit and the decision below could have no effect upon their excess profits tax liabil-

---

* Any appeal from the decision to be rendered by the Tax Court in the *May, Stern* case would lie to the Third Circuit Court of Appeals. The amount of tax involved in this issue in the *May, Stern* case is $38,798.65.

** The excess profits tax was enacted by §201 of the Second Revenue Act of 1940. It was repealed with respect to all taxable years beginning after December 31, 1945 by §122(a) of the Revenue Act of 1945.

ities. In the second place, many, if not most, installment sellers who did use the invested capital credit made the election provided by §736(a) I. R. C. (enacted by §222(d) of Revenue Act of 1942) authorizing such taxpayers to elect to compute (for excess profits tax purposes) their income from installment sales on the accrual basis in lieu of the basis provided by §44(a). The present case did not involve an election under §736(a) and is therefore not controlling in the case of taxpayers who made such an election. (See the decision of the Fourth Circuit in the *Kimbrell's* case, *supra* (159 F. (2d) 608), holding, in the case of a taxpayer which made the election under §736(a), that its uncollected profits from installment sales were includible in its earnings and profits for the purpose of the invested capital credit. As pointed out above, no application for certiorari was made by the Government in that case.)

The decision below does not effect a change in the law with respect to the determination of earnings and profits for dividend purposes. The question of the includibility of uncollected profits from installment sales in earnings and profits for the purpose of dividend distributions was decided by the Fifth Circuit in 1943 in the *Shenandoah* case, *supra* (138 F. (2d) 792). The court held that such profits were includible for that purpose and based its decision upon the provisions of §115(d). From the standpoint of taxing distributions to stockholders, this holding was favorable to the Government in that it prevented non-taxable distributions by installment sellers out of uncollected gains. No application for certiorari was made in the *Shenandoah* case. Under these circumstances there is clearly no merit in the Government's contention that the decision below, which

simply followed the *Shenandoah* case, will require it to reopen the tax liabilities of stockholders for prior years.

The further statement in the petition (footnote 2) that "administrative practice has treated distributions as not constituting dividends where they were paid out of gains which had not yet been recognized by the corporation for its income tax purposes" (meaning by this, gains which had not been subjected to tax) is also incorrect. The regulations (Reg. 111, §29.115-3) provide that "Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under Section 22(a)." What has been excluded from earnings and profits, as a matter of administrative practice, is gain that has not been recognized under §112. The exclusion of such gains is now required by §115(l). But neither §115(l) nor administrative practice excludes gains from earnings and profits simply on the ground that they have not been subjected to tax.

In the court below the Commissioner was obliged to concede that there were numerous instances in which gains that had not been taxed, and losses which were not allowable as deductions, entered into the computation of earnings and profits. Among the instances of this kind listed in the Government's brief below (pp. 30, 47-8) were: increment in value of property acquired prior to March 1, 1913 realized upon subsequent sale of the property, losses disallowed under §24(b) on sales to a controlling stockholder, capital losses to the extent not allowed as a deduction, exempt income, and capital gains realized in the United States by a foreign corporation not engaged in business here. These instances show that there is no basis for

the Government's claim that, under administrative practice, gains which have not entered the computation of a corporation's taxable income are excluded from its earnings and profits.

(b) The decision below is in accord with §115(l) and the Treasury Regulations promulgated thereunder.

There is no foundation for the Government's assumption that only gains which have been taxed are "recognized" within the meaning of §115(l).

(i) The Government's position would result in the absurdity, pointed out above (p. 4), that gains from installment sales to the extent not taxed in the year of sale could never be included in earnings and profits. Section 115(l) requires not only that gain be recognized but that it be recognized under the law of the "year in which such sale or disposition was made". This means that unless the gain is recognized in the year of sale, as the court below held that it was, it can never enter into the computation of earnings and profits. Even if the gain were recognized under the law of some year other than the year of sale, that would not satisfy the requirement of the statute. Therefore, the only sensible construction that can be placed upon the statute is the one placed upon it by the court below.

(ii) The full amount of the gain from an installment sale must be regarded as recognized in the year of sale for the reason, if for no other, that under the express provisions of §44 the full amount of such gain enters into the computation of the fraction of each cash payment which is to be reported by the seller as taxable income (see Reg. 111, §29.44-1).

(iii) The Government's contention is denied by the the very regulations which the Commissioner has promul-

gated under §115(l), by T. D. 5024, 1940-2 C. B. 110. These regulations provide (Reg. 111, §29.115-12):

> "As used in this subsection [§115(l)] the term 'recognized' has reference to *that kind* of realized gain or loss which is recognized for income tax purposes by the statute applicable to the year in which the gain or loss was realized, for example, see section 112. A loss * * * may be recognized *though not allowed as a deduction* (by reason, for example, of the operation of sections 24 (b) and 117 and corresponding provisions of prior revenue laws) but *the mere fact that it is not allowed does not prevent decrease in earnings and profits by the amount of such disallowed loss.* * * * The 'recognized' gain or loss for the purpose of computing earnings and profits is determined by applying the recognition provisions to the realized gain or loss computed under the provisions of section 115(l) *as distinguished from the realized gain or loss used in computing net income.*" (Italics added.)

Example 2 in this regulation is a case where "for the purpose of computing net income the gain is only $800" but where, by the same transaction, total earnings and profits are "increased by $1,900." Although $1,100 of the gain is not taxed, it is nevertheless held to be "recognized in computing net income under the law applicable to the year in which such sale or disposition was made," and, therefore, includible in earnings and profits under §115(l).

These regulations confirm that gain or loss is recognized within the meaning of §115(l) if, in the year of sale, it was of the kind recognized under §112 of the Code or a corresponding provision of the prior revenue acts, and that if gain or loss is so recognized it enters into the determination of earnings and profits regardless of whether it entered into the computation of taxable income.

(iv) The Government's contention is inconsistent with the statutory definition of "recognition" which the Code makes applicable "for the purposes of this chapter", *i.e.*, Chapter 1, containing §115(l). Section 111(c) provides:

> "(c) RECOGNITION OF GAIN OR LOSS.—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this chapter, shall be determined under the provisions of section 112."

Section 112(a) provides:

> "(a) GENERAL RULE.—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section."

None of the exceptions contained in §112 to the general rule stated in §112(a) are material here; as the petition agrees (footnote 3). Therefore, under the statute the full gain from installment sales is recognized in the year of sale.

Despite the all-inclusive provisions of §112(a), the Commissioner urges that §§44 and 111(d) are non-recognition provisions in so far as they authorize the return of gains from installment sales in a year other than the year of sale. But these sections do not purport to be recognition sections, nor do they contain anything which in substance or effect provides that an installment sale, to the extent of the uncollected profits thereon, is not recognized. Recognition simply means that gain or loss is deemed to have occurred. As Mr. Justice Jackson said in *Comm'r* v. *Wheeler*, 324 U. S. 542, 546 (1945):

> "Congress has determined that in certain types of transaction the economic changes are not definitive enough to be given tax consequences, and has clearly

> provided that gains and losses on such transactions shall not be recognized for income-tax liability but shall be taken account of later. §§112, 113."

It is clear that §§44 and 111(d) do not treat installment sales as transactions in which "the economic changes are not definitive enough to be given tax consequences."

Only if recognition were deemed to be equivalent to taxation could §§44 and 111(d) be regarded as non-recognition sections. That recognition and taxation are not equivalent is demonstrated by the existence of numerous instances, referred to at page 8 above and also in the regulation quoted at page 10 above, in which gain is recognized within the meaning of the statute although not included in taxable income.

The Government made no attempt below to reconcile its position with the existence of cases in which untaxed gain is admittedly "recognized" under the statute other than to say that they were "exceptions". But the fact that all these so-called "exceptions" exist disproves the Government's claim that recognition and taxation are equivalent.

(v) In 1941, the year following the enactment of §115(l) and the promulgation thereunder of the regulations now contained in §29.115-12 of Reg. 111, quoted at page 10 above, the Commissioner (by T. D. 5059, 1941-2 C. B. 125) added the following provisions to another section of the regulations (now §29.115-3 of Reg. 111):

> "• • • the amount of the earnings or profits in any case will be dependent *upon the method of accounting properly employed in computing net income.* For instance, • • • a corporation computing income on the installment basis as provided in section 44 shall, with respect to the installment transactions, compute earnings and profits on such basis; • • •." (Italics added.)

Since the regulation amended was by its terms applicable only to the determination of the earnings and profits of a given period (as distinguished from total earnings and profits), the above-quoted provisions do not, strictly speaking, apply in a case involving determination of total earnings and profits for the purpose of computing a corporation's equity invested capital. Beyond this, however, the above-quoted provisions, in so far as they would require gain from an installment *sale* to be returned for taxation before inclusion thereof in earnings and profits, are in direct conflict with §115(l) and therefore cannot be supported.* The provisions of §115(l) that gains *from sales* shall increase earnings and profits "to, but not beyond, the extent to which" such gains are recognized under the law of the year of sale, are exclusive and permit of no implied exceptions based on accounting practice, taxation or otherwise.

(c) The decision below in no way conflicts with *Comm'r* v. *Wheeler*, 324 U. S. 542 (1945).

The petition for the writ asserts (pp. 12-13) that the *Wheeler* case in principle overruled the *Shenandoah* case upon which the lower court relied. This argument was also made by the Government to the Fourth Circuit in the *Kimbrell's* case and was rejected by that court which cited and followed the *Shenandoah* case. The argument was accepted by Judge Holmes in the court below, but without reasons given. (Judge Holmes had also dissented in the *Shenandoah* case.)

The contention is based, not upon any inconsistency between the decisions, but upon a complete and obvious misstatement of the grounds of the decision in the *Shenandoah* case, to wit, that such decision was based upon a

* The above-quoted provisions also conflict with the provisions of the regulations, quoted at page 10 above, which expressly deal with the effect of §115(l) on earnings and profits.

line of cases, such as *Comm'r* v. *F. J. Young Corp.*, 103 F. (2d) 137 (C. C. A. 3d, 1939), which were overruled by the *Wheeler* case. The *Shenandoah* case did *not* purport to follow such line of cases. On the contrary, the *Shenandoah* case recognized that such cases were no longer authoritative in view of the enactment of §115(l). The sole question considered in the *Shenandoah* case was whether uncollected profits from installment sales were recognized within the meaning of §115(l). The Commissioner contended, as here, that they were not because no tax had been paid thereon. The court rejected that argument, saying, per Hutcheson, Cir. J. (p. 794):

> "* * * Nothing in Sec. 501 [§115(l) I. R. C.] limits, or purports to limit, earnings and profits from sales of property to those which were 'recognized' by the taxpayer as taxable to him in the year in which the dividend was declared. It merely limits them to such as were 'recognized', in computing net income, under the law applicable to the year in which the sales were made, and it stands conceded that the Revenue Act of 1936, the law applicable, clearly recognizes the receipts in this case as gains, and, but for the option to defer payment of taxes on them it would have subjected the taxpayer to taxes on them in the year of their receipt. *All that Section 501 [§115(l)] does, all that it was intended to do, is to limit usable earnings and profits from sales of property to that portion of the gain realized which is taxable, and there is nothing in it which restricts such usable profits to those gains only which are returned for taxation in the year of their realization.*" (Italics added.)

In the *Wheeler* case the corporation involved had sold certain property and realized a gain thereon which was recognized under §112. The stockholders contended that the gain was not includible in earnings and profits for the

purposes of determining whether a distribution to them was a taxable dividend. Their contention was based upon the fact that from an accounting standpoint the corporation, instead of having gain from the sale, had sustained a loss. They relied upon the *Young* case, *supra*, and similar lower court cases holding that earnings and profits were to be determined in accordance with accounting concepts.

This Court considered the question independently of §115(l), which had been enacted after the year involved, and held that the gain was to be included in earnings and profits to the extent recognized under §112, and that it was immaterial that from an accounting standpoint the sales had resulted in a loss. In so holding this Court said, per Mr. Justice Jackson (pp. 546, 547):

> "But 'earnings and profits' in the tax sense, although it does not correspond exactly to taxable income, does not necessarily follow corporate accounting concepts either. * * * as the Commissioner's regulation directs: gains and losses are to be brought into earnings and profits at the time and 'to the extent' that they are recognized under §112."

This being the sum and substance of the *Wheeler* case, how can it be seriously urged that the *Wheeler* case in principle overruled the *Shenandoah* case, which likewise held that gains from sales, to the extent recognized under §112, were to be included in earnings and profits.

(d) Decisions rendered under the Revenue Act of 1918 are clearly distinguishable because such act contained no provision comparable to §115(l).

The petition asserts (pp. 14-15) that the decision below is in conflict with the decisions of other circuits under a "corresponding provision" of the Revenue Act of

1918. The provision referred to was a provision for the inclusion in invested capital of "paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during the year" (Rev. Act 1918, §326(a)(3)). The 1918 Act contained no provision corresponding to §115(l), which the Government concedes is the controlling section here. Consequently the question here involved was not raised in or decided by the earlier cases.

The cases decided under the 1918 Act took the view that uncollected installment profits were not includible in earnings and profits because they were "earnings" of the year in which the payments were received. This view was predicated on the courts' conception of "installment accounting." Since these cases followed accounting concepts instead of the statutory concept of recognition, they would have to be regarded as overruled by the *Wheeler* case, even if §115(l) had not been enacted. And, of course, by the enactment of §115(l) Congress has forbidden the determination of earnings and profits, so far as sales and exchanges are concerned, on any basis other than the statutory concept of recognition.

Conclusion.

The petition for a writ of certiorari should be denied.

Respectfully submitted,

J. Arthur Platt,
Attorney for Respondent.

November, 1947.

IN THE

Supreme Court of the United States

OCTOBER TERM—1947.

No. 384.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

SOUTH TEXAS LUMBER COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

BRIEF FOR THE RESPONDENT.

CHARLES C. MACLEAN, JR.,
Counsel for Respondent,
31 Nassau Street,
New York, N. Y.

ARTHUR A. BALLANTINE,
J. ARTHUR PLATT,
RAY I. HARDIN,
Of Counsel.

January, 1948.

INDEX.

Table of Citations

Cases

STATUTES

REGULATIONS

OTHER AUTHORITIES

IN THE

Supreme Court of the United States

OCTOBER TERM—1947.

No. 384.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

SOUTH TEXAS LUMBER COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

BRIEF FOR THE RESPONDENT.

This is a proceeding to review a judgment of the Circuit Court of Appeals for the Fifth Circuit which reversed a decision of The Tax Court of the United States. The Tax Court had found that there was a deficiency in the federal excess profits tax of respondent for the year 1943. The amount of the deficiency in controversy is $1,708.53 (R. 30).

Opinions Below.

The opinion of the Tax Court (R. 30) is reported in 7 T. C. 669. The majority (R. 51) and dissenting (R. 54) opinions in the Circuit Court of Appeals are reported in 162 F. (2d) 866.

Jurisdiction.

The jurisdiction of this Court is invoked under §240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

Question Presented.

Whether, under §115(l) of the Internal Revenue Code, the respondent's profits from installment sales are includible in full in its earnings and profits as of the beginning of subsequent years for the purpose of computing its invested capital credit for such years under the excess profits tax.

Statutes and Regulations Involved.

The statutes and regulations involved are set out in the Appendix, *infra*, pp. 49-59.

Statement of Case.

(a) How the question arises.

The respondent taxpayer, a corporation, sold parcels of real estate in 1937, 1938 and 1941, gave deeds therefor to the purchasers and received in payment cash and promissory notes executed by the purchasers, payable to the order of the taxpayer, and secured in each case by vendor's lien and mortgage lien against the land (R. 31). The taxpayer keeps its books and files its income and excess profits tax returns on the calendar year and accrual basis (R. 31). The taxpayer, being on the accrual basis of accounting, carried on its books as receivables the installment obligations received from such sales (R. 31). The gain from such sales was reported for income tax and excess profits tax purposes

under the installment provisions contained in §44(b)* (R. 31).

The taxpayer computed its excess profits tax by use of the credit for invested capital as authorized by §§710 and 712 (R. 17, 22-23). The credit, which is against excess profits net income, was, in the case of the taxpayer, 8% of its invested capital (§714) (R. 17). The definition of invested capital involves the determination of the corporation's "equity invested capital" which is defined as including "the accumulated earnings and profits as of the beginning of such taxable year" (§718(a)(4)).

The taxpayer computed its excess profits credit for 1943, and its unused excess profits credit carry-overs from 1941 and 1942, by including in its accumulated earnings and profits at the beginning of such years the full amount of its profits on installment sales made in previous years (R. 33-34). The Tax Court held that the taxpayer's earnings and profits did not include the portion of such profits allocable to installments which had not been collected. The Tax Court rested its decision upon its prior decision in *Kimbrell's Home Furnishings, Inc.*, 7 T. C. 339 (1946), afterwards reversed by the Fourth Circuit Court of Appeals (159 F. (2d) 608 (1947)).

The court below reversed the decision of the Tax Court. In so doing the court below followed its prior decision in *Comm'r* v. *Shenandoah Co.*, 138 F. (2d) 792 (1943), holding that uncollected profits from installment sales were includible in earnings and profits for the purpose of determining whether a distribution to stockholders was a dividend. The Commissioner agrees that, although a different tax is involved, the ultimate question here is precisely the same as the question presented in the *Shenan-*

* Unless otherwise indicated all section references are to the Internal Revenue Code.

doah case and is governed by the same statute there involved, *viz.*, §115(l) (petitioner's brief, p. 13).

Section 115(l), which is conceded to be controlling here, was not discussed or even referred to by the Tax Court either in its decision in the present case or in its prior decision in the *Kimbrell* case, which it followed here.

(b) The issues.

If the taxpayer had not elected to report the gains from such sales on the installment basis, the full amount of such gains would have been taxable in the years the sales were made (Reg. 111, §§29.44-3, 29.44-4) and, as the court below pointed out (R. 53), the Commissioner would then concede that the profits from such sales were fully includible in the taxpayer's earnings and profits at the dates involved even though a part of such gains remained to be collected. There is, therefore, no objection to the includibility of such profits on the ground that they had not been collected, *i.e.*, that they were represented by installment obligations payable in the future.

The sole ground of objection by the Commissioner to the includibility of the uncollected profits in respondent's earnings and profits as of the beginning of the taxable years involved is that the respondent, having availed itself of the privilege of reporting such profits on the installment basis, had not previously paid an income tax thereon.

The taxpayer's position is that the case is controlled by §115(l), enacted by §501 of the Second Revenue Act of 1940. Section 115(l) defines the effect on earnings and profits of gain or loss from the sale or other disposition of property. The section is controlling in the determination of the invested capital credit under the excess profits tax as well as in the determination of whether a distribution is a dividend.

Under the terms of that section the full amount of the taxpayer's gains from its installment sales was required to be included in the earnings and profits of the taxpayer because such gains were (i) realized upon the sale and (ii) were "recognized in computing net income under the law applicable to the year" of sale. No other requirements are contained in §115(l) for inclusion of gain in earnings and profits. Specifically, there is no requirement in §115(l) that gain (or loss) must be included in (or deducted from) taxable income before it "shall increase or decrease the earnings and profits."

In the court below, and again in the petition for certiorari, the Commissioner's principal contention was that the portion of the taxpayer's profits from its installment sales which had not been included in taxable income was not recognized within the meaning of §115(l). His brief below argued (p. 48): "* * * recognition of gain from the sale or other disposition of property for tax purposes involves its inclusion in gross income under the method of returning income used by a taxpayer." His petition for certiorari asserted (p. 10) that "the gain on an installment sale is 'recognized' under Sections 111 and 112 to the extent that it is subjected to tax in a given year under Section 44." This contention, which was based upon the false premise that "recognition" and "taxation" are synonymous, is given little weight in the Commissioner's brief here.

Instead, the Commissioner's principal reliance (Point A of petitioner's brief) is on an amendment made to the Treasury Regulations on July 8, 1941 by T. D. 5059 (1941-2 C. B. 125) which provides that a corporation computing income on the installment basis shall, with respect to its installment transactions, compute earnings and profits on such basis, *i.e.*, that only the portion of installment

gains which has been returned for taxation is includible in earnings and profits (Reg. 111, §29.115-3). The taxpayer's answer to this regulation is that it provides a requirement for inclusion in earnings and profits which is contrary to the unambiguous provisions of §115(l) and also to the regulations which the Treasury had promulgated thereunder on December 19, 1940 by T. D. 5024 (1940-2 C. B. 110), now contained in Reg. 111, §29.115-12.

The Commissioner endeavors (Point B (5) of petitioner's brief) to reconcile the 1941 amendment to the Regulations with the provisions of §115(l) on the theory that the amendment deals with the time when gain or loss enters into the computation of earnings and profits, which subject, he implies, is not dealt with in §115(l). The taxpayer's answer to this contention is that §115(l) *does* determine the time when gain or loss "shall increase or decrease" earnings and profits. Earnings and profits can only be determined as of a given date, and §115(l) governs the determination of earnings and profits on such date, whatever it may be. Therefore if, as of the date earnings and profits are to be determined, gain or loss meets the tests of realization and recognition specified in §115(l), such gain or loss must enter the computation of earnings and profits at that date.

Summary of Argument.

Section 115(l) provides that the gain realized from the sale of property (determined on the bases specified in that section) shall increase earnings and profits to, but not beyond, the extent to which such a gain was recognized in computing net income under the law applicable to the year of sale. On the dates in question, the taxpayer's gains from its installment sales made in prior years satisfied the

tests of realization and recognition contained in §115(l) because such gains had been realized in full in the year of sale and recognized in full under the law of the year of sale. Such gains were, therefore, required to be included in the taxpayer's earnings and profits at the dates in question.*

The taxpayer's gains from its installment sales were realized in full at the time of sale because the taxpayer then received the full amount of the selling price in money or money's worth. The secured obligations of the purchasers which the taxpayer received were worth their face value. The taxpayer's gains from its installment sales were no less realized because the taxpayer elected to report such gains for taxation under §44. Realization of gain is not postponed by the fact that the taxpayer is not required to pay an immediate tax thereon. Section 44 acknowledges this because it in terms refers to "the gross profit realized" from a sale and thereby presupposes the determination of realization under other provisions of the statute. The gain realized from an installment sale is therefore to be determined under §111. If the obligations received are worth face, the full amount of the gain is realized upon the sale. Only where the value of the money and obligations received is less than the selling price does any gain remain to be realized subsequent to the sale. The relevant authorities uniformly support the taxpayer's position.

The taxpayer's profits from its installment sales were recognized in full under the law of the year of sale. Section

---

* Since §115(l) governs the determination of earnings and profits not only for the purpose of computing the invested capital credit of a corporation, but also for the purpose of determining whether distributions by a corporation are dividends to its stockholders, the position taken by the Commissioner here, if well founded, would mean that a corporation with available funds could, prior to collecting installment obligations held by it, distribute the uncollected portion of its installment gains to its stockholders free of dividend tax.

111(c) provides that "for the purposes of this chapter" the recognition of gain shall be determined under the provisions of §112. Section 112(a) provides that upon a sale the entire amount of the gain, determined under §111, shall be recognized, with exceptions not material here. The statutory phrase used in §115(l), "recognized in computing net income under the law applicable to the year in which such sale or disposition was made", means gain or loss of the kind recognized under §112 of the Code, or corresponding provisions of prior Revenue Acts, applicable to the year of sale.

The phrase in question does not mean that gain must be included in taxable income before it can be deemed recognized within the meaning of §115(l). On the contrary, §115(l) was designed to provide for the inclusion in earnings and profits of gain or loss that had not entered into the determination of taxable income. This is illustrated by the provisions of the section for inclusion in total earnings and profits of increase in value accrued before March 1, 1913 (which is not subject to tax) when the property is subsequently sold. This illustration and other examples of items which affect earnings and profits in a manner different from that in which they affect taxable income, are contained in the Regulations promulgated under §115(l). (Reg. 111, §29.115-12.) These Regulations and the legislative history of §115(l) (including the amendment of the section by the Revenue Act of 1942, regarding wash sales) fully support the taxpayer's construction of §115(l) as referring to gains recognized under §112 rather than to gains included in taxable income.

To construe the phrase "recognized in computing net income" as meaning included in or deducted from taxable income, would deprive the statute of sensible meaning. The statute would then be made to read: "included in or

deducted from taxable income under the law applicable to the year *in which such sale or disposition was made.*" Such a reading of the statute would exclude from earnings and profits gain or loss included in or deducted from taxable income in a year subsequent to the year of sale. This would follow from the fact that inclusion in taxable income under the law of a year *subsequent to the year of sale* would not meet the statutory test. In the case of installment sales, this would mean that no gains reported for taxation in years subsequent to the year of sale could ever enter the corporation's earnings and profits. They could, therefore, be distributed to the corporation's stockholders free of dividend tax.

Petitioner's brief in substance concedes that the phrase "recognized in computing net income" cannot be construed as meaning included in or deducted from taxable income. It states (p. 27) that the phrase in question "merely fixes the law in effect during the year of sale as being controlling". If this is the sole effect of the phrase, it cannot require that gain be included in taxable income before it is includible in earnings and profits.

Since at the dates in question the taxpayer's gains from its installment sales satisfied the tests of realization and recognition, which are the only tests specified in §115(l), it is immaterial that they did not satisfy a third test imposed by the amendment to the Regulations upon which the Commissioner relies (T. D. 5059, now reflected in Reg. 111, §29.115-3). Such amendment, made subsequently to the promulgation of the Regulations under §115(l), provides that earnings and profits shall be determined in accordance with the method of accounting employed in computing net income, and specifies that a taxpayer who reports income on the installment basis shall, with respect to installment sales, compute its earnings and profits on that basis. The

taxpayer submits that this change in the Regulations is, as to installment sales, squarely in conflict with the provisions of §115(l) and therefore invalid. Excess profits tax cases arising under the Revenue Act of 1918, and decided prior to the enactment of §115(l), cannot justify the addition of such provision to the Regulation after the enactment of §115(l).

The amendment to the Regulation cannot be justified on the theory that it deals merely with the time when gain or loss is included in earnings and profits. The question of the time of inclusion is governed by §115(l), which was intended to settle that question. Neither can the change in the Regulation be justified on the authority of *Comm'r* v. *Wheeler*, 324 U. S. 542 (1945), where the Court pointed out in the course of its opinion that " 'earnings and profits' in the tax sense, although it does not correspond exactly to taxable income, does not necessarily follow corporate accounting concepts, either." The *Wheeler* case did not hold, as the petitioner's brief asserts (p. 21), that the time of inclusion in earnings and profits is to be correlated with the time when gain is subjected to tax. The case held that the includibility of gains from sales in earnings and profits is to be determined under the recognition provisions of §112. Section 115(l) is to the same effect.

The court below properly held, on the authority of its prior decision in *Comm'r* v. *Shenandoah Co.*, 138 F. (2d) 792 (1943), that the taxpayer's gains from its installment sales were includible in full in its earnings and profits for the purpose of determining its invested capital credit.

ARGUMENT.

I.

Under §115(l) the taxpayer's earnings and profits at the dates in question are required to include the full amount of taxpayer's profits from its installment sales made prior thereto because such profits were realized in the year of sale and were recognized under the law of that year.

A. Section 115(l) is controlling.

The parties are agreed that §115(l) (Appendix, *infra*, p. 53) is controlling on the question presented, *viz.*, the determination of respondent's earnings and profits for the purpose of its invested capital credit under the Excess Profits Tax Act of 1940, enacted by §201 of the Second Revenue Act of 1940. The Excess Profits Tax Act of 1940, which is contained in Subchapter E of Chapter 2 of the Internal Revenue Code (§710, *et seq.*), does not define the term "accumulated earnings and profits." (See Reg. 112, §35.718-2, Appendix, *infra*, p. 59). Such Act provides, however, that "the terms used in this subchapter shall have the same meaning as when used in Chapter 1" (§728).

The Second Revenue Act of 1940, in §501 thereof, also amended Chapter 1 of the Code by adding subsection (l) to §115. Section 115(l), among other things, defines the effect on earnings and profits of gain or loss from the sale or other disposition of property by a corporation. The purpose of §115(l) was stated by the Committee on Ways and Means in H. R. Rep. No. 2894, 76th Cong., 3rd Sess. (1940-2 C. B. 496, 526) as follows (p. 41):

"The purpose of this amendment is to clarify the law with respect to what constitutes earnings and profits of a corporation. This is important not only for the purpose of determining whether distributions are taxable dividends *but also in determining equity invested capital for excess-profits-tax purposes.*" (Italics added.)

As the Commissioner's petition for certiorari states (p. 11), "any residual doubts as to the applicability of Section 115(l) * * * would be resolved by the legislative history of the statute * * *."

B. The effect of §115(l).

Section 115(l) provides in part as follows:

"(l) EFFECT ON EARNINGS AND PROFITS OF GAIN OR LOSS AND OF RECEIPT OF TAX-FREE DISTRIBUTIONS.—The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

(1) for the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to

which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made."*

The meaning of these provisions must be determined in the light of the provisions of §§111, 112 and 113. Those sections, like §115(l), are found in Supplement B (of Chapter 1 of the Code) entitled: "Computation of Net Income" (Appendix, *infra*, pp. 52-53). Section 111 provides, in subsection (a) thereof, that the amount of gain or loss from the sale or other disposition of property shall be determined by subtracting the taxpayer's basis for the property from "the amount realized" from the sale thereof. Section 111(b) defines "the amount realized" from a sale as "the sum of any money received plus the fair market value of the property (other than money) received." Section 111(c) provides:

> "(c) RECOGNITION OF GAIN OR LOSS.—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized *for the purposes of this chapter*, shall be determined under the provisions of section 112." (Italics added.)

Section 112, entitled "Recognition of Gain or Loss", provides:

> "(a) GENERAL RULE.—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section."

---

* Paragraph (1) of §115(l) specifies the basis to be used in "the computation of the total earnings and profits of the corporation, of most frequent application in determining invested capital" (Reg. 111, §29.115-12). Paragraph (2) of §115(l) specifies the basis to be used in "the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, of most frequent application in determining the source of dividend distributions" (*ibid.*).

No exception thereinafter contained in §112 is applicable to installment sales of property.*

Section 113 contains the provisions for determining the taxpayer's basis for the property sold which, under §111, is to be subtracted from the amount realized in determining the amount of gain or loss from the sale.

The effect of §115(l) is, therefore, to provide that, for the purpose of determining the earnings and profits of a corporation,

> (i) The gain or loss realized upon a sale or other disposition of property shall be determined in accordance with §111 except as the provisions of §113 regarding the basis to be used in determining the amount of the taxpayer's gain or loss are modified by the provisions of paragraph 1 or 2 of §115(l), and
>
> (ii) The amount of the gain or loss so determined shall increase or decrease earnings and profits "to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made," *i.e.*, the extent to which such a gain or loss was recognized under §112 of the Internal Revenue Code or corresponding provisions of the prior Revenue Acts applicable to the year of sale.

---

* Section 112(j) refers to the provisions of subsection (d) of §44 requiring non-recognition of gain or loss in the case of the distribution of installment *obligations* in the course of a corporate liquidation which, under the provisions of §112(b)(6), does not result in the recognition of gain or loss with respect to the receipt of such obligations. There is no similar reference in §112 either to the provisions of subsections (a) and (b) of §44 or to installment *sales* of property as such.

The taxpayer's position is that the gain from its installment sales was realized in full in the year of sale for the reasons stated in Point IC below, and was recognized in full under the law of the year of sale for the reasons stated in Point ID below, and that therefore the full amount of such gain is required to be included in the computation of the taxpayer's earnings and profits in years subsequent to the year of sale.

C. The taxpayer's profits on its installment sales were realized in full, in money or money's worth, in the year of sale.

1. Under the provisions of §111 the taxpayer realized gains from its installment sales to the extent that the money and value of the obligations received exceeded the taxpayer's basis for the property sold.

As stated above, §111(b) defines "the amount realized" from the sale of property as "the sum of any money received plus the fair market value of the property (other than money) received." Section 111(a) defines the gain from the sale as "the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) for determining gain". In the present case the amount of the gain so determined is the same as the amount of gain computed under §115(l). The reason is that the adjusted basis provided in §113(b) for determining gain for the purpose of inclusion in gross income is, in the present circumstances, the basis prescribed by §115(l) for use in computing the amount of gain realized for the purpose of determining earnings and profits.

The matter of valuation of obligations received on a sale is dealt with in the Regulations. They provide (Reg. 111, §29.111-1):

> "The amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property which is received. The fair market value of property is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value."

The Regulations further provide (Reg. 111, §29.44-4):

> "* * * the obligations of the purchaser received by the vendor are to be considered as the equivalent of cash to the amount of their fair market value in ascertaining the profit or loss from the transaction.
>
> * * * * * *
>
> "If the obligations received by the vendor have no fair market value, the payments in cash or other property having a fair market value shall be applied against and reduce the basis of the property sold, and, if in excess of such basis, shall be taxable to the extent of the excess. * * * Only in rare and extraordinary cases does property have no fair market value."

The obligations received by the taxpayer consisted of promissory notes payable to the taxpayer's order and were secured by the land sold (R. 31). The obligations received were taken on the taxpayer's books at face value (R. 31) and the Commissioner has made no determination that the obligations were worth less than that amount. Such obligations must therefore be deemed to have had a value equal to their face.[9]

---

[9] *Pinellas Ice & Cold Storage Co.* v. *Comm'r*, 287 U. S. 462 (1933); *Rusk* v. *Comm'r*, 53 F. (2d) 428 (C. C. A. 7th 1931); *Peyton Du-Pont Securities Co.* v. *Comm'r*, 66 F. (2d) 718 (C. C. A. 2d 1933); *Wolfson* v. *Reinecke*, 72 F. (2d) 59 (C. C. A. 7th 1934); *Moran* v. *United States*, 85 Ct. Cls. 492, 19 F. Supp. 557 (1937), *cert. denied*, 303 U. S. 643 (1938); *W. B. Packman*, 2 B. T. A. 508 (1925); *H. J. Kelly*, 3 B. T. A. 257 (1925); *J. S. Cullinan*, 5 B. T. A. 996 (1927).

As the Regulations under §111 provide (Reg. 111, §29.111-1):

> "The amount which remains after the adjusted basis has been restored to the taxpayer constitutes the realized gain."

Therefore, to the extent that the sum of the money and face value of the obligations received by the taxpayer exceeded its basis for the property sold, the taxpayer had a realized gain.

2. The taxpayer's gains were no less "realized" because the taxpayer elected to report such gains for taxation under §44.

The brief for the Commissioner contends (p. 8) that "under Section 44 * * * gains are realized and recognized when installment payments are actually received in cash".* This contention appears to be grounded on the proposition that the provisions of §§41 to 44, inclusive, relating to the time when items of gross income and deductions are reported for the purposes of taxation, may somehow operate to postpone realization and recognition. (The question of the effect of §44 on recognition is discussed in Points ID and IIA below.) With respect to realization, the contention is unsound for the following reasons:

First, it disregards the provisions of §111 which make it plain that realization is a factual matter which is determined by the *receipt* of money or property. Section 111 defines "the amount realized from the sale" in terms of the money and property "received". This Court has recently had occasion to construe §111 in determining the amount realized upon the sale of mortgaged property.

* Although the Commissioner's assignment of errors in the petition for certiorari raises an issue as to whether the profits from installment sales were "recognized" in full (p. 6), he made no claim that the court below committed error in holding that the full amount of such profits was "realized" in the year of sale.

Crane v. *Comm'r*, 331 U. S. 1 (1947). The Court held that the amount of a mortgage on the property sold was to be included in the amount realized by the seller, although the seller was not liable on the mortgage. *A fortiori*, the actual receipt of installment obligations upon a sale comes within the definition of realization where such obligations have value.

Where the value of the money and obligations received is equal to selling price, the gain is realized in full at the time of sale. Only where the value of the money and obligations received is less than selling price does any gain remain to be realized at a subsequent date. (Reg. 111, §§29.44-4 and 29.111-1.)

Secondly, §§41 to 44, inclusive, having to do with the time that gains and deductions are to be reported for the purposes of taxation, do not purport to affect the question of the time of realization determined under §111. Section 42, which deals with items of gross income generally,* provides:

> "(a) GENERAL RULE.—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period."

Section 41 provides that in computing net income, the method of accounting regularly employed in keeping the taxpayer's books shall be used unless such method does not clearly reflect income.**

---

* The gain from a sale, as determined under §111, constitutes an item of gross income. §§22(a) and 22(f); *Doyle* v. *Mitchell Bros. Co.*, 247 U. S. 179 (1918).

** The Regulations under §41 provide (Reg. 111, §29.41-2):

> "Section 44 contains special provisions for *reporting the profit derived* from the sale of property on the installment plan." (Italics added.)

Presumably in reliance on provisions like those of §42, the Commissioner promulgated regulations in 1918 and 1919 providing for the use of an installment method in reporting gain. These regulations are referred to at page 22 of the petitioner's brief, where it is pointed out that after the Board of Tax Appeals had held the regulations invalid in a series of cases decided in 1925, Congress in §212(d) of the Revenue Act of 1926 enacted the installment sales provisions now contained in §§44(a) and (b)* See *Burnet v. S. & L. Building Corp.*, 288 U. S. 406 (1933).

Section 44, dealing with the reporting of gain on the installment basis, like §42, dealing with gross income generally, does not purport to define realization. On the contrary, §44 postulates the determination of realized gain under other provisions of the statute and thereby negatives any suggestion that realization occurs only as amounts are returned as income under the computation which the section authorizes. Section 44(a) provides that an installment seller "may return as income * * * that proportion of the installment payments actually received * * * which the gross profit realized or to be realized when payment is completed, bears to the total contract price". In terms, therefore, the statute contemplates that the full amount of the gain may have been realized upon the sale.

The amount realized on an installment sale would be determined under §111.** Under that section a taxpayer

---

* Section 44(a) deals with a person who regularly sells personal property on the installment plan. Section 44(b) provides that in certain cases a person who makes a casual sale of personal property or a sale of real estate may return the income therefrom in the manner prescribed by §44(a).

** Reg. 111, §29.111-1 provides:

"The general method of computing such gain or loss is prescribed by section 111 * * *.

"In the case of property sold on the installment plan, special rules for the *taxation* of the gain are prescribed in section 44." (Italics added.)

selling on the installment basis realizes gain to the extent that the value of the property received exceeds basis (Reg. 111, §§29.44-4 and 29.111-1, *supra*). If the fair market value of the property received is less than the total selling price, additional gain will be realized in subsequent years when and if the obligations received are satisfied (*ibid.*). In any case, however, whether gain has been realized in full or whether all or a portion of the gain remains to be realized, the taxpayer is accorded the right to elect to report the gain under §44. But the fact that the taxpayer has such an election in no way detracts from the fact that the profits from the sale are realized in full under the provisions of §111 where, as here, the taxpayer receives the sales price in money or money's worth, i. e., where the obligations received are worth face.

Thirdly, the provisions of §111(d) plainly imply that the gain from an installment sale is realized in accordance with the provisions of §§111(a) and (b). Section 111(d) provides:

> "Installment Sales.—Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received."*

* Petitioner's brief (p. 29) cites §111(d) for the proposition that the gain from an installment sale is "derived" only as payments are received. This contention is based on the Commissioner's treatment of the statutory phrase "in the year in which such payment is received" as modifying "gain or profit". The purpose of the subsection, however, is to sanction *taxation* "in the year in which such payment is received" of the portion of any installment payment representing gain or profit. Accordingly, the phrase "in the year in which such payment is received" is to be taken as modifying "taxation" and not "gain or profit" as the Commissioner would have it appear.

In substance the statute says that notwithstanding the fact that the gain from an installment sale is realized upon the sale it may, nevertheless, be *taxed* in subsequent years as installment payments are received. The use of the phrase "Nothing in this section shall be construed to prevent" shows that the subsection is a precaution against any claim that because gain was realized in the year of sale it may not be taxed in a subsequent year.* Such a precaution would not have been necessary if gain from an installment sale were realized only as payments were received.

In order to support his claim that the time of realization of the gain from an installment sale is governed by the time the gain is reported under §44, the Commissioner asserts (petitioner's brief, p. 29) that the term "taxation" as used in §111(d) "contemplates not only the imposition of the tax, but every step necessary thereto." In this manner it is implied that until gain is taxed it is not realized. This indeed is the silent premise of the Commissioner's argument based on the provisions of §§41-44 governing the time of taxation. But the underlying assumption that gain which is not taxed is not realized would not bear express assertion. Section 112 contains a long list of instances in which realized gain as determined under §111 is not recognized and hence is not subjected to tax. Additional instances of realized gains which are not subjected to tax for reasons other than non-recognition are contained in Point ID below.

3. The authorities are uniformly to the effect that gains from installment sales are realized in full in the year of sale where the obligations received are worth face.

In *Burnet* v. *S. & L. Building Corp.*, 288 U. S. 406 (1933), this Court had before it the question of the validity of

---

* An installment sales case in which this type of claim was made is *Louis Werner Saw Mill Co.* v. *Helvering*, 96 F. (2d) 539 (App. D. C., 1938).

the regulations promulgated by the Commissioner under §44, then §212(d) of the Revenue Act of 1926. The question arose in connection with sales of real estate by a taxpayer on the accrual basis who elected to report his gains on the installment basis. The precise question was the treatment to be accorded assumed mortgages in the computation of the portion of each payment to be reported in each year. In upholding the regulations the Court approved a determination by the Commissioner of the "realized profit" from the sales as the excess of the money and mortgages (both received and assumed) over the seller's basis. After pointing out that the purpose of the installment provisions was to alleviate the hardship on vendors of having to pay in a single year the total tax on installment sales, the Court said (p. 414):

> "The amounts which respondent realized as profits are not in question. These were subject to taxation either upon the accrual basis or, at the taxpayer's option, on the installment basis. Generally, the Commissioner's regulations permitted the tax payments to be spread over the period during which the taxpayer would receive funds, and divided these partly into return of capital and partly into profits actually collected."

Comm'r v. *Shenandoah Co.*, 138 F. (2d) 792 (C. C. A. 5th, 1943), relied upon by the court below, held that the gains from the installment sales there involved were both realized and recognized within the meaning of §115(l) in the year of sale.* The *Shenandoah* case presented the question whether

---

* In the *Shenandoah* case a corporation sold building lots in 1936 and 1937 on the deferred payment plan and elected to report its gains therefrom under §44 of the Revenue Act of 1936. The corporation, which was on the accrual basis of accounting, carried all the installment obligations on its books as receivables. Except

such profits were includible in full in earnings and profits for dividend purposes but, apart from the different bases prescribed in paragraphs 1 and 2 of §115(l), the includibility of amounts in earnings and profits is determined in exactly the same way for dividend purposes under paragraph 2 as for invested capital purposes under paragraph 1. (See petitioner's brief, pp. 13, 16.)

In holding that the Shenandoah Company's gains from its installment sales were realized in full in the year of sale the court said, per Hutcheson, Cir. J. (p. 794):

> "Usually, of course, the year of realization is the year of taxation, and this would be the case here but for the use of the installment option. This, while deferring payment of the taxes to a later year, does not change the fact that the income was in fact realized in the year in which the obligations were received. Indeed, it establishes that it was, for otherwise there would be no occasion to provide for deferring the payment. We think it plain, therefore, that the Tax Court was right in holding that dividends paid out of earnings taxable when received, under the Revenue Act applicable to the year in which the sales were made, though under the option not taxed to them in those years, were paid out of surplus, and allowable as a dividends paid credit, and that its judgment must be affirmed."

Circuit Judge Holmes dissented solely on the question of recognition discussed *infra*. He said (p. 795):

---

for the fact that the corporation availed itself of the provisions of §44, all of its profits from the sales would have been taxable income in the year of sale. The corporation made a distribution to its stockholders in 1937. It showed a surplus available for such distribution by including in its earnings and profits the gain represented by its uncollected installment obligations. The Commissioner contended that such gain was not includible in earnings and profits and that the corporation was therefore not entitled to a dividend carryover from 1937 to 1938 under the provisions of §27(b)(2) of the Revenue Act of 1936.

> "Its [the corporation's] profits were realized in 1937, but were not recognized in its tax returns because it elected to exercise its option to report such income on the installment basis."

Even the decision of the Tax Court in the *Kimbrell* case, relied upon by the Tax Court in the present case, acknowledged that the gains involved in the *Shenandoah* case had been realized, the Tax Court saying with respect to the *Shenandoah* case that there "the total gain on the sale of each lot was realized at the time of sale and under either the cash or accrual basis would have been taxable in the year thereof but for the election under section 44(b)" (7 T. C. 339, 344). The situation of the taxpayer in the *Shenandoah* case, both with respect to the facts of its installment sales and its method of keeping books and reporting income, is indistinguishable from the situation of the taxpayer in the present case and the Tax Court in its decision below made no attempt to distinguish the two situations.

The decision of the Circuit Court of Appeals for the Fourth Circuit in the *Kimbrell* case (159 F. (2d) 608) held that the gains from the installment sales there involved were realized at the time of sale for the reasons given in the *Shenandoah* case and in the cases discussed immediately below.*

---

*The Circuit Court of Appeals in the *Kimbrell* case also held that the gains in question were "recognized in computing net income under the law applicable to the year in which such sale or disposition was made." As the petitioner's brief points out (footnote 2), the facts of the *Kimbrell* case are different from those here involved in that the taxpayer there reported its income from installment sales for excess profits tax purposes on the accrual basis, pursuant to §736(a), although it continued to report such income for income tax purposes under §44. However, in attempting to show that the reasoning of the *Kimbrell* case has no applicability to the present case, the petitioner's brief states (footnote 2) that the decision in that case was rested:

In several cases arising under §44(d) the courts have held that gains from installment sales were realized in the year of sale. Section 44(d) was added by the Revenue Act of 1928 to prevent the evasion of taxes in connection with the seller's transfer of installment obligations to others who took them at an increased basis and as a result paid no additional income tax thereon except to the extent that amounts collected exceeded such basis. See Report of Committee on Ways and Means, H. R. Rep. No. 2, 70th Cong., 1st Sess., p. 16 (1939-1 C. B., Part 2, 384, 394). That report described the effect of the installment method as follows:

> "The installment basis accords the taxpayer the privilege *of deferring the reporting* at the time of sale of *the gain realized*, until such time as the deferred cash payments are made." (Italics added.)

In cases involving a tax assessed under §44(d) against a decedent, based on transmission of installment obligations at his death, the position was taken on behalf of the decedent's estate that, since no gain was realized upon the decedent's death, the tax was unconstitutional. In each case the court rejected the argument and held that, although no gain was realized upon the decedent's death, profits from the installment sales had been realized in the year of the sale and would have been taxable in such year except for

---

> "* * * upon the ground that, since the taxpayer there reported upon the accrual basis for purposes of the excess profits tax, uncollected profits on installment sales were 'recognized,' as well as realized (p. 612)—*'because they are taken into consideration in computing the part of the sales price to be included in the excess profits net income and subjected to the excess profits tax.'*" (Italics added.)

Actually, this reasoning is applicable to the present case, since the full amount of the taxpayer's profit from an installment sale was used in determining the fraction of each installment payment received which was reported as income for excess profits tax purposes as well as income tax purposes.

the privilege of deferring the tax granted by §44, which privilege was terminated at death.* In *Alexander M. Crane*, 30 B. T. A. 29 (1934), the Board of Tax Appeals said (p. 30):

> "* * * the gain subject to tax on the death of the owner of installment obligations is the gain realized on the sale of the property in connection with which the installment obligations were received, and the taxation of which was merely deferred under the installment sales provisions of the taxing statute."

This decision was affirmed in *Crane* v. *Helvering*, 76 F. (2d) 99 (C. C. A. 2d, 1935), where the court said (pp. 100-101):

> "The statute might have taxed at once a gain based upon the value of the bond and mortgage, for that was 'realized' as soon as they were received. *Pinellas Ice & Cold Storage Co.* v. *Commissioner*, 287 U. S. 462 * * *; *Rusk* v. *Com'r.*, 53 F. (2d) 428 (C. C. A. 7); *Wolfson* v. *Reinecke*, 72 F. (2d) 59 (C. C. A. 7). It is true that in these cases the obligations were all short term notes, while here it was a bond and mortgage; but the principle is the same in either case. If a note or other promise, payable in a later taxable year, is 'realized' on its receipt, it can make no difference how long the payment is deferred; whether for ten years, or for only one."

In *Nuckolls* v. *United States*, 76 F. (2d) 357 (C. C. A. 10th, 1935), the court, in reaching a similar conclusion, said (p. 360):

* Petitioner's brief states (footnote 11) that this line of cases supports the view that realization (and recognition) of the gain from an installment sale take place "at least in part" in the year in which the installment obligations were disposed of. This suggestion is not well founded because, as stated above, one of the reasons for adding subsection (d) was that no gain is realized on transmission by death.

> "* * * the sale made on November 2, 1929, gave rise to taxable income in the amount of the difference between $33,600 and the price for which the stock was sold—$105,000 if the notes were then worth their face. Whatever their value, the gain, if any, was then realized and taxable. The taxpayer was given the option to pay a tax on only a part of the realized gain during that year upon condition that if he died or sold the notes, he would pay an additional tax calculated on the then value of the notes."

In accord are *Lawler* v. *Comm'r*, 78 F. (2d) 567 (C. C. A. 9th, 1935) and *Moore* v. *United States*, 80 Ct. Cls. 842, 10 F. Supp. 143 (1935), *cert. denied*, 296 U. S. 583 (1935). See *Gump* v. *Comm'r*, 124 F. (2d) 540, 543 (C. C. A. 9th, 1941), *cert. denied*, 316 U. S. 697 (1942); *Estate of Henry H. Rogers*, 1 T. C. 629, 639 (1943), *aff'd*, 143 F. (2d) 695 (C. C. A. 2d, 1944).

D. The taxpayer's profits on its installment sales were recognized in full under the law of the year of sale.

As stated above, §111(c) provides that the extent to which the gain or loss from a sale "shall be recognized for the purposes of this chapter, shall be determined under the provisions of section 112," and §112(a) provides that upon a sale "the entire amount of the gain or loss, determined under section 111, shall be recognized," with exceptions not material here. The taxpayer's position is that since the full amount of the gains from its installment sales was recognized under the provisions of §112 which were in effect in the year of each sale,* such gains satisfy the recognition requirement of §115(l).

---

* The laws applicable to the years in which the sales here in question occurred are the Revenue Act of 1936, the Revenue Act of 1938, and the Internal Revenue Code, as the same have been amended. There is no significant difference in the relevant provisions of §§44, 111, 112 and 115(l) as they appear in the several Acts here applicable.

Although the petitioner's brief does not stress the point, it appears to adhere to the position heretofore taken by the Commissioner that the phrase contained in §115(l), "recognized in computing net income under the law applicable to the year in which such sale or disposition was made," does not refer to gain or loss recognized under §112 of the Code and corresponding provisions of prior Revenue Acts, but refers to gain (or loss) which the taxpayer has included in (or deducted from) taxable income. In the petitioner's brief the contention appears at pages 8 and 29 as an assertion that gain from an installment sale is recognized only as cash payments are actually received and reported under §44. (This construction of the phrase "recognized in computing net income," is hardly consistent with the statement at page 27 of petitioner's brief that "the foregoing provision merely fixes the law in effect during the year of sale as being controlling." See discussion *infra*, p. 35.)

It is submitted that the court below correctly rejected such contention on the authority of the decision of that court in the *Shenandoah* case (138 F. (2d) 792), discussed above (pp. 22-24). In answer to a similar contention, the court in the *Shenandoah* case said (p. 794):

> "* * * Nothing in Sec. 501 [§115(l)] limits, or purports to limit, earnings and profits from sales of property to those which were 'recognized' by the taxpayer as taxable to him in the year in which the dividend was declared. It merely limits them to such as were 'recognized', in computing net income, under the law applicable to the year in which the sales were made, and it stands conceded that the Revenue Act of 1936, the law applicable, clearly recognizes the receipts in this case as gains, and,

but for the option to defer payment of taxes on them it would have subjected the taxpayer to taxes on them in the year of their receipt. All that Section 501 [§115(l)] does, all that it was intended to do, is to limit usable earnings and profits from sales of property to that portion of the gain realized which is taxable, and there is nothing in it which restricts such usable profits to those gains only which are returned for taxation in the year of their realization."

The construction placed upon §115(l) in the *Shenandoah* case is, of course, the construction for which the taxpayer contends here. It is supported by analysis of the language of §115(l), the provisions of the regulations promulgated thereunder, and the legislative history of the section.

1. **Section 115(l) was designed to provide for the inclusion in earnings and profits of gain or loss which had not entered into the computation of taxable income.**

(a) ***Section 115(l) provides for inclusion in total earnings and profits of increase in value accrued before March 1, 1913 which has not been subjected to tax.***

Paragraph 1 of §115(l) prescribes certain rules which are to be used in the computation of the total earnings and profits of a corporation for the purpose of determining its invested capital. It provides that in computing total earnings and profits the amount of the gain or loss from the sale or other disposition (after February 28, 1913) of property shall be determined by the use of the adjusted basis for determining gain (as defined in §113(b)), except that no regard is to be had to the value of the property as of March 1, 1913. In the computation of taxable income, however, §113(a)(14) provides that, in the case of property acquired before March 1, 1913, if the fair market value of the property as of March 1, 1913 is greater than its adjusted basis

at that date, then the basis for determining gain shall be such fair market value.

The result is that in such a case (*i. e.*, where March 1, 1913 value exceeds adjusted basis at that date) the amount of the gain determined under paragraph 1 of §115(l) for the purpose of inclusion in total earnings and profits would be greater than the amount of the gain determined under §113(a)(14) for the purpose of computing taxable income.*

The point may be illustrated as follows: A corporation acquired non-depreciable property in 1910 for $1,100. On March 1, 1913 the fair market value of the property was $2,200. In 1942 the corporation sold the property for $3,000. Under paragraph 1 of §115(l) the full gain of $1,900 would be includible in total earnings and profits. That is because under paragraph 1 of §115(l) such gain is determined without regard to the value of the property as of March 1, 1913. And yet $1,100 of such $1,900 gain would *not* have entered into the computation of the corporation's taxable income, and no tax would have been paid thereon, because under §113(a)(14) regard *is* had to March 1, 1913 value in determining the basis of the property for the purpose of computing the tax.**

---

* The Regulations under §115(l) point out that there may be a disparity between the taxable income arising from a sale and the effect of the sale on earnings and profits. Reg. 111, §29.115-12 provides:

> "The 'recognized' gain or loss for the purpose of computing earnings and profits is determined by applying the recognition provisions to the realized gain or loss computed under the provisions of section 115(l) *as distinguished from the realized gain or loss used in computing net income.*" (Italics added.)

** The foregoing example is substantially the same as Example 2 contained in the Regulations promulgated under §115(l) (Reg. 103, §19.115-12, now contained in Reg. 111, §29.115-12). That example is of a case where "for the purpose of computing net income the gain is only $800" but where the total earnings and profits are "increased by $1,900."

The provision:

> "Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made."

applies to the gain determined under paragraph 1 of §115(l) and requires inclusion in the total earnings and profits of the full amount of such gain—both the part thereof which is includible in taxable income and the part thereof which is not. If that were not so, *i. e.*, if the untaxed portion of the gain were deemed not to be "recognized in computing net income under the law applicable to the year in which such sale or disposition was made," then the very purpose of providing in paragraph 1 that "no regard shall be had to the value of the property as of March 1, 1913" would be defeated. That purpose was to include in total earnings and profits the increase in value of property accrued before March 1, 1913 when subsequently realized, notwithstanding that such increase is not subjected to tax because of the provisions of §113(a)(14). Therefore, increase in value accrued before March 1, 1913 and realized thereafter must be deemed to be "recognized in computing net income under the law applicable to the year in which such sale or disposition was made."

This analysis shows that the full amount of gain from a sale may be "recognized in computing net income under the law applicable to the year in which such sale or disposition was made" although only a portion of such gain is taxed under the law applicable to such year, and that all that is necessary in order for gain to be recognized within the meaning of §115(l) is that the gain be of a kind that was

recognized under the provisions of §112 of the Code or corresponding provisions of prior Acts applicable to the year of sale. The fact that gain is not taxed in the year of sale, whether because of statutory exclusion from gross income or for some other reason (other than non-recognition thereof under the law of the year of sale), is immaterial.

(b) *The taxpayer's construction of §115(l) is confirmed by the provision regarding wash sales, added to the section by the Revenue Act of 1942.*

Section 146(a) of the Revenue Act of 1942 amended §115 (l) by adding the following sentence:

> "For the purposes of this subsection, a loss with respect to which a deduction is disallowed under section 118, or a corresponding provision of a prior income-tax law, shall not be deemed to be recognized."

The purpose of this amendment was stated by the Committee on Ways and Means in H. R. Rep. No. 2333, 77th Cong., 2d Sess. (1942-2 C. B. 372, 442), as follows (pp. 92-93):

> "Under section 115(l) of the Code reference is made to the basis of property prescribed by section 113, and unrecognized gains or losses are disregarded, in computing the earnings or profits of a corporation resulting from a disposition by it of such property. While section 118 of the Code disallows a loss from wash sales of securities, and section 113 (a)(10) adjusts the basis of the new securities for the amount of the disallowed loss, *no provision in the Code specifies that the disallowed wash-sale loss shall be considered as not recognized* for the purposes of computing such earnings and profits. Thus, an improper duplication results in the computation of earnings and profits under section 115(l), contrary to the uniform practice prior to the enactment of sec-

tion 501 of the Second Revenue Act of 1940." (Italics added.)

The amendment made to the statute in 1942 would have been unnecessary under the Commissioner's construction of §115(l). The loss from a wash sale is not allowed as a deduction (§118). Therefore, such a loss could not have affected earnings and profits if, as the Commissioner contends, gain or loss must enter into the computation of taxable income before it can be considered "recognized" within the meaning of §115(l). Congress considered, however, that a loss from a wash sale was recognized within the meaning of §115(l) because such a loss, although not deductible, was recognized under §112. And, as the above-quoted committee report shows, Congress amended the statute not because the loss from a wash sale is excluded from the computation of taxable income but because, under §113(a)(10), such loss is added to the basis of the property reacquired, which would ultimately result in a double reduction of earnings and profits on account of a single loss. The construction which Congress placed upon §115(l) when it made this amendment is, therefore, directly opposed to the Commissioner's contention.

(c) *The meaning which the Commissioner would give the phrase "recognized in computing net income" conflicts with the construction required by the phrase which follows immediately, "under the law applicable to the year in which such sale or disposition was made".*

In the court below the brief for the Commissioner made the easy assumption that the words "recognized in computing net income" meant included in or deducted from taxable income. From this it was argued that gains from installment sales which had not been included in taxable income were not recognized within the meaning of §115(l).

In addition to the internal conflict to which such a construction of the statute would lead, as shown above, it would have the further effect of depriving the statute of sensible meaning because it would exclude from earnings and profits gain or loss included in or deducted from taxable income in a year subsequent to the year of sale.

If, as the Commissioner has contended, the words "recognized in computing net income" are to be construed as saying "included in or deducted from taxable income" the statutory phrase would then read: "Included in or deducted from taxable income under the law applicable to the year *in which such sale or disposition was made.*" But a taxpayer can compute its net income for any year only under the law applicable to that particular year. Therefore, if gain or loss is reported or deducted in a year subsequent to the year of sale, it is included in the computation of net income under the law applicable to such subsequent year.*

It follows that *if* the Commissioner's construction of §115(l) were correct (that only gains or losses which have been included in or deducted from taxable income are "recognized in computing net income" within the meaning of the statute), then *whenever gain or loss is reported in a year subsequent to the year of sale such gain or loss could never affect earnings and profits* under §115(l) because it would have been included in the computation of taxable income under the law applicable to the subsequent year rather than "under the law applicable to the year in which such sale or disposition was made".

---

* For this reason it has been held that an installment payment received in 1938 on account of an installment sale made in 1936 is taxable in accordance with the capital gains provisions in effect in 1938 rather than those in effect in 1936. *Harry B. Golden*, 47 B. T. A. 94 (1942).

The consequence of such a construction in the case of installment sales would be that all gains reported in years subsequent to the year of sale could be distributed by the selling corporation to its stockholders free of the tax on dividends. On the other hand, where a loss was excluded from the computation of taxable income in the year of sale (e.g., the excess of capital losses over capital gains under §117(d)(1)) but carried over to a subsequent year where it was allowable as a deduction to the extent of capital gains of that year (§117(e)), the loss could never decrease earnings and profits because it would be allowed as a deduction in the computation of net income only under the law of a year subsequent to the year of sale.

The consequence is that the phrase "recognized in computing net income under the law applicable to the year in which such sale or disposition was made" can be given a sensible meaning only by construing it, as the *Shenandoah* case did, as referring to gain or loss of the kind recognized under the provisions of §112 of the Code, or corresponding sections of the prior Revenue Acts, applicable to the year of sale, rather than to gain or loss that has been included in computing taxable income.

Petitioner's brief (p. 27) misinterprets the foregoing contention of the taxpayer and endeavors to answer it by pointing out that the phrase in question "merely fixes the law in effect during the year of sale as being controlling". But this argument of the Commissioner gives the phrase the construction for which the taxpayer contends, viz., that under the phrase "recognized in computing net income under the law applicable to the year in which such sale or disposition was made" the test is not whether the gain has been subjected to tax in the year of sale or at any other time but whether the gain is *of the kind* which was recognized under the law of the year of sale. Such construction of the phrase

"recognized in computing net income under the law applicable to the year in which such sale or disposition was made" is quite the opposite of its construction as meaning included in or deducted from taxable income.

2. The Treasury Regulations promulgated under §115(l) acknowledge that recognition under §115(l) is governed by the provisions of §112 and not by inclusion of gain or loss in taxable income.

The taxpayer's construction of §115(l) is entirely supported by the following provisions of the Regulations thereunder (Reg. 111, §29.115-12):

> "The gain or loss so realized increases or decreases the earnings and profits to, but not beyond, the extent to which such gain or loss was *recognized* in computing net income under the law applicable to the year in which such sale or disposition was made. As used in this subsection the term 'recognized' has reference to *that kind* of realized gain or loss *which is recognized for income tax purposes by the statute* applicable to the year in which the gain or loss was realized, for example, see section 112.* *A loss* (other than a wash sale loss with respect to which a deduction is disallowed under the provisions of section 118 or corresponding provisions of prior revenue laws) *may be recognized though not allowed as a deduction* (by reason, for example, of the operation of sections 24(b) and 117 and corresponding provisions of prior revenue laws) *but the mere fact that it is not allowed does not prevent decrease in*

---

* Reg. 111, §29.115-3 contains the following cross-reference to this section of the Regulations:

> "Gains and losses within the purview of section 112 or corresponding provisions of prior Revenue Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section (see section 29.115-12)."

earnings and profits by the amount of such disallowed loss. Wash sale losses, however, disallowed under section 118 and corresponding provisions of prior revenue laws, are deemed nonrecognized losses and do not reduce earnings or profits. The 'recognized' gain or loss for the purpose of computing earnings and profits is determined by applying the recognition provisions to the realized gain or loss computed under the provisions of section 115(l) *as distinguished from the realized gain or loss used in computing net income.*" (Italics added except as to word "recognized" in first sentence.)*

Section 24(b) provides, among other things, that no deduction shall be allowed in respect of a loss from the sale of property by a corporation to an individual controlling more than half of its stock. Nevertheless, since such loss is recognized under §112, the above-quoted regulations provide that it shall decrease earnings and profits.

Section 117(d)(1) provides, in the case of corporations, that losses from sales of capital assets shall be allowed only to the extent of gains from such sales. But although the excess of such losses over such gains is not allowed as a deduction, such excess is recognized under §112 and, therefore, the above-quoted Regulations provide that such excess of loss shall decrease earnings and profits.

So also a gain may be recognized though not includible in taxable income, but the fact that it is not so includible does not prevent increase in earnings and profits by the amount thereof. The example given in the Regulations is discussed above, in Point ID(1), paragraph (a). Another

---

* Except for the references to losses disallowed under §118 (discussed in paragraph (b) of Point ID(1)), the language of this Regulation is largely borrowed from the committee reports. See Sen. Rep. No. 2114, 76th Cong., 3rd Sess., p. 23 (1940-2 C. B. 528, 545) and H. R. Rep. No. 3002, 76th Cong., 3rd Sess., p. 60 (1940-2 C. B. 548, 563).

illustration is afforded in the case of distributions by a foreign corporation to United States stockholders. (The provisions of §115 apply to such distributions. *Untermyer* v. *Comm'r*, 59 F. (2d) 1004 (C. C. A. 2d, 1932), *cert. denied*, 287 U. S. 647 (1932); Reg. 111, §29.115-1.) Where a foreign corporation, not engaged in trade or business within the United States, sells securities here at a gain, such gains are not included in the corporation's taxable income (§231(a)). But even though no tax had been paid thereon, such gains would undoubtedly be regarded as recognized within the provisions of §115(l) so as to constitute part of the corporation's earnings and profits for the purpose of determining whether distributions by the corporation to United States stockholders were taxable as dividends.

3. The legislative history of §115(l) fully supports the taxpayer's construction of that section as referring to gains recognized under §112 rather than gains included in computing taxable income.

The particular change in preexisting case law which the provisions of §115(l) here in question was intended to effect, was to establish a correspondence, so far as sales and exchanges are concerned, between earnings and profits and the recognition provisions of §112. This is shown by the following passage of the report of the Committee on Ways and Means on the bill proposing §115(l) (H. R. Rep. No. 2894, 76th Cong., 3rd Sess., pp. 41-2; 1940-2 C. B. 496, 526):

> "Section 401 of the bill inserts subsection (l) in section 115 of the Internal Revenue Code and correspondingly amends prior Revenue Acts. The rule, applied by the Treasury under existing law, is that while gains or losses which are not recognized by reason of the provisions of section 112 neither increase nor diminish the earnings or profits, the earnings or profits are increased or diminished by *the*

entire amount of the recognized gain or loss, computed in accordance with the provisions of sections 111, 112, and 113. Together with the provisions of section 115(h) of the Internal Revenue Code, and the principles established in *Commissioner* v. *Sansome*, (60 F. (2d) 931) and following decisions, *the rule effectuates the provisions of section 112.* While taxpayers generally have concurred in the rule applied by the Treasury, the Board of Tax Appeals and some of the courts have not agreed but have followed the theory that gain or loss, even though not recognized in computing net income, nevertheless affects earnings and profits." (Italics added.)

The report continues with a reference to *Comm'r* v. *F. J. Young Corp.*, 103 F. (2d) 137 (C. C. A. 3rd, 1939) as such a case. As petitioner's brief states (footnote 10) it was the purpose of §115(l) to overrule the *Young* case. The sole question involved in the *Young* case was whether a realized gain should be included in a corporation's earnings and profits where §112(b)(5) of the Revenue Act of 1928 expressly provided that such gain should not be recognized. The *Young* case held the gain includible. Other cases which had declined to apply the recognition provisions in the computation of earnings and profits were *Comm'r* v. *McKinney*, 87 F. (2d) 811 (C. C. A. 10th, 1937) and *Comm'r* v. *W. S. Farish & Co.*, 104 F. (2d) 833 (C. C. A. 5th, 1939).

The reference in the report to Treasury practice shows a purpose to incorporate into the Code provisions substantially similar to those which had been contained in the Regulations since 1934,* to wit:

---

* Reg. 86, Art. 115-1, under the 1934 Act; Reg. 94, Art. 115-3, under the 1936 Act; Reg. 101, Art. 115-3, under the 1938 Act; Reg. 103, Sec. 19.115-3, under the Internal Revenue Code. These Regulations contained nothing comparable to the provision added to the Regulations by the 1941 amendment upon which the Commissioner relies here (Petitioner's brief, Point A).

> "Gains and losses within the purview of section 112 or corresponding provisions of prior Revenue Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section."

The legislative history shows no purpose on the part of Congress to define earnings and profits in terms of income that had been subjected to tax. And yet the important differences which had long existed between the determination of earnings and profits and the computation of taxable income could hardly have escaped Congressional notice. The Regulations have long contained a provision for inclusion in earnings and profits of "all income exempted by statute" and income not taxable under the Constitution (Reg. 111, §29.115-3). The differences existing between the determination of earnings and profits and the computation of taxable income had also frequently been stated by the courts and the Board of Tax Appeals. For example, in *R. M. Weyerhaeuser*, 33 B. T. A. 594 (1935) it was said (p. 597):

> "Earnings and profits, on the other hand, are not defined by the act; but they have a settled and well defined meaning in accounting. Generally speaking, they are computed by deducting from gross receipts the expense of producing them. *Mobile & Ohio Railroad* v. *Tennessee*, 153 U. S. 486, 497; Fletcher Cyclopedia Corporations, vol. 6, p. 6092. Thus, under the ordinary method of accounting, in computing earnings and profits there will be deducted, not only the items shown above, but others which are not, under the statute, deductible in computing taxable net income. In this classification may be listed such items as extraordinary expenses, charitable contributions, taxes paid the Federal Government, and taxes assessed against local benefits tending to increase the value of the property [citing cases]. Again, many

items, such as interest upon the obligations of a state or political subdivision, tax-free Federal securities, and dividends from other corporations, must necessarily be considered in computing earnings and profits, though forming no part of taxable net income.'"*

When the legislative history of §115(l) is considered against this background, it seems apparent that by the provisions in question Congress was seeking to do only one thing, to wit, to make the recognition provisions of §112 govern the determination of earnings and profits in the case of sales, and that Congress had no purpose to go beyond the recognition provisions and make inclusion of gain in earnings and profits dependent upon whether it had been subjected to tax.

II.

The change in the Regulations upon which the Commissioner relies is, as to installment sales, in conflict with the provisions of §115(l) and therefore is invalid.

In Point I of this brief it has been shown that the taxpayer's gains from its installment sales are required by §115(l) to be included in the taxpayer's earnings and profits at the dates involved because, at such dates, the

* Among the numerous instances, in addition to those mentioned in the quotation, of items which affect taxable income differently than they affect earnings and profits are: net operating loss carry-overs and capital loss carry-overs (which decrease taxable income but do not decrease earnings and profits); recoveries of bad debts and prior taxes excluded from income under §22(b)(12) and the proceeds of life insurance policies excluded from income under §22(b)(1) (which increase earnings and profits but are not included in taxable income); and expenses disallowed under §24(c) and premiums on life insurance disallowed under §24(a)(4) (which decrease earnings and profits but do not decrease taxable income).

gains satisfied the only two tests specified in §115(l), viz., realization and recognition. It is therefore immaterial that such gains did not meet a third test, imposed by an amendment made to the Commissioner's regulations in 1941, that installment gains be reported in taxable income before inclusion thereof in earnings and profits.*

The taxpayer submits that the change in the Regulations is, as to installment sales, in conflict with the statute

---

* By T. D. 5059 of July 8, 1941 (1941-2 C. B. 125) the following provisions were added to Reg. 103, §19.115-3 (now Reg. 111, §29.115-3):

> "• • • the amount of the earnings or profits in any case will be dependent upon the method of accounting properly employed in computing net income. *For instance, • • • a corporation computing income on the installment basis as provided in section 44 shall, with respect to the installment transactions, compute earnings and profits on such basis;* • • •." (Italics added.)

Prior to such amendment, the Commissioner had promulgated the Regulations under §115(l) which did not impose any requirement of the kind imposed by the above-quoted amendment. (T. D. 5024 of December 19, 1940; 1940-2 C. B. 110.) The Regulations promulgated under §115(l) were contained in §19.115-12 of Reg. 103, and are now contained in Reg. 111, §29.115-12.

The same Treasury decision (T. D. 5059) which made the above-quoted amendment also amended Reg. 109, §30.718-2 (relating to the meaning of "accumulated earnings and profits" for purposes of the excess profits tax) by adding a specific reference to the provisions of Reg. 103, §19.115-3, as amended, "relating to the computation of earnings and profits in the case of a corporation computing net income on the cash, accrual, or installment basis • • •". Reg. 109, §30.718-2 as so amended, was superseded, however, by Reg. 112, §35.718-2 in which all reference to the provisions added by the 1941 amendment was omitted. Regulations 112, which were promulgated January 25, 1944, were made applicable to taxable years beginning after December 31, 1941 and also "where it is appropriate" to taxable years beginning after December 31, 1939 and before January 1, 1942.

In view of the above history of the changes in the Regulations and the fact that the only reference in Reg. 112, §35.718-2 to the Regulations under §115 is to "certain transactions" rather than to accounting methods, it seems unwarranted to state, as the petitioner's brief does (p. 16), that such reference "leaves no doubt" that the 1941 amendment applies here.

and therefore invalid. *Trust of Bingham* v. *Comm'r*, 325 U. S. 365 (1945). As this Court said in *Koshland* v. *Helvering*, 298 U. S. 441, 447 (1936): "But where, as in this case, the provisions of the act are unambiguous, and its directions specific, there is no power to amend it by regulation." And if there were no such conflict here between §115(l) and the amended Regulation, there would then be a serious question whether the Regulation, as it is sought to be applied here with respect to the taxpayer's installment sales, was a proper exercise of the Commissioner's discretion. As the Circuit Court of Appeals for the Fourth Circuit said in the *Kimbrell* case (159 F. (2d) 608, 611):

> "When the intrinsic nature of the uncollected profits on installment obligations is considered, no reason appears why they should not be treated as a part of the invested capital credit within the meaning of the phrase 'accumulated earnings and profits' contained in Section 718(a)(4) of the Code. They are assets of the business which can be pledged or sold and may be subjected to attachment or execution."

A. The change in the Regulations cannot be justified on the theory that it deals merely with the time when gain or loss is included in earnings and profits. The question of the time of inclusion is governed by §115(l).

Petitioner's brief attempts to justify the change in the Regulation in question on the ground that it deals merely with the time when gains from installment sales increase earnings and profits—a matter which, it is implied, is not controlled by §115(l). Petitioner's brief points out (pp. 8, 30) that the provisions of §111, defining realization, and of §112, defining recognition, do not contain any provision regarding the time when gain or loss enters into the computation either of net income or earnings and profits.

The argument is that since the time for inclusion of realized and recognized gains in taxable *income* is governed by the provisions of §§41-44, the same sections should be considered as governing the inclusion of items of gain in *earnings and profits*. By failing to discuss the provisions of §115(l) as to time of inclusion of gains in earnings and profits, petitioner's brief implies that the section does not specify the time of inclusion, so that the Commissioner is left free to provide for this omission by regulation. The answer to this contention is that §115(l) *does* provide for the time of inclusion of gain or loss in earnings and profits.

The section provides how earnings and profits are to be determined. Earnings and profits can be determined only as of a given date. The date is always essential. Section 115(l) provides, therefore, that if, at any date as of which earnings and profits are to be determined, gain or loss has been realized and has been recognized under the law of the year of sale, such gain or loss "shall increase or decrease the earnings and profits" on such date. The language of the statute is mandatory, and gives neither the Commissioner nor the corporation power to postpone the inclusion of any gain in earnings and profits once such gain has met the tests of realization and recognition. It is, therefore, beside the point to argue that the Regulation in question deals only with the time of inclusion of gain or loss in earnings and profits. The question of time of inclusion in earnings and profits is the very question which the statute was designed to settle and there is no room for importing therein the provisions of §§41-44 dealing with the time of inclusion of gain in taxable income.*

---

* As to items which are not controlled by §115(l), the taxpayer does not contend that the time of inclusion of income in earnings and profits of items of income and expense may not appropriately be determined by the method of accounting employed by a tax-

B. The change in the Regulations cannot be justified on the basis of the holding of the *Wheeler* case that the includibility of gains from sales in earnings and profits is to be determined under the provisions of §112.

Petitioner's brief asserts (p. 21) that the holding of this Court in *Comm'r* v. *Wheeler*, 324 U. S. 542 (1945), "correlates not only the extent to which, but the time when, gain shall be brought into earnings and profits with the extent to which and the time when such gain shall enter into the computation of net income." This statement is incorrect. The *Wheeler* case correlates earnings and profits with recognition under §112.

The *Wheeler* case involved the question of the effect on a corporation's earnings and profits of a sale by the corporation of securities for which its basis as determined under §113 was lower than the book value of the securities as determined in accordance with principles of corporate accounting. The proceeds of the sale exceeded the tax basis but were less than the book value. As a result, the corporation had a realized gain under §111 of the Revenue Act of 1938 which was recognized in full under the provisions of §112 of that Act although from an accounting point of view it

---

payer." Indeed, the legislative history of §115(l) indicates that Congress contemplated that apart from the matters covered by the section, earnings and profits would be determined in accordance with the best accounting practice. See H. R. Rep. No. 2894, 76th Cong., 3rd Sess. 43 (1940-2 C. B. 496, 527).

Since the question here is controlled by §115(l), it is unnecessary to discuss whether the installment basis is "a separate and independent method of accounting and one that is co-equal with the cash and accrual bases", as stated in petitioner's brief (p. 23). However, it may be doubted whether a statutory basis of return, which is applicable only to certain items of gross income, and which is not at all applicable to deductions, should be regarded as an independent method of accounting. The situation of the taxpayer illustrates the point. It was stipulated, and the Tax Court found, that the taxpayer keeps its books and files its tax returns on the *accrual* basis but that it elected, with respect to certain transactions, to report the gain therefrom on the basis authorized by §44 (R. 26, 31).

had suffered a loss on the transaction. This Court held that notwithstanding the fact that the corporation had suffered a loss from an accounting point of view, its earnings and profits were to be increased by the amount of the gain recognized under §112 of the Revenue Act of 1938.

The Court rejected the contention that earnings and profits were to be determined in accordance with accounting costs instead of tax basis and held that the recognition provisions of §112 were controlling not only in the determination of taxable gain but in the determination of earnings and profits. In so holding the Court said (p. 546):

> "It was no doubt permissible and perhaps the correct accounting, for determining earned surplus for dividends and such corporate purposes, for the corporation to set up its books on the market value of its property at the time of acquisition, which determined the value of the stock it issued. *But 'earnings and profits' in the tax sense, although it does not correspond exactly to taxable income, does not necessarily follow corporate accounting concepts, either.*" (Italics added.)

The change in the Regulation, which is based on accounting principles rather than on the provisions of §112, certainly cannot be justified by the *Wheeler* case.

The Court's holding was made independently of §115(l) which had been enacted in 1940, subsequent to the year involved. The Court reasoned that, by §112, Congress had "determined that in certain types of transaction the economic changes are not definitive enough to be given tax consequences" and that it was sensible and, indeed, required by the provisions of §111(c), that such determination be reflected in the computation of earnings and profits. Clearly, installment sales do not fall within the category of transactions which Congress has deemed not definitive enough

to be given tax consequences. All that §44 does is to grant an option to spread the payment of the tax on a transaction which would otherwise be taxed immediately.

The dissenting judge in the court below thought that the *Shenandoah* case had "in principle been overruled" by the *Wheeler* case (R. 54). The Commissioner so argued in the court below but such argument is not made here. Petitioner's brief does state (footnote 10) that the *Shenandoah* case was based "at least in part" upon the theory of the *Young* case, and similar cases, which were overruled both by §115(l) and by the *Wheeler* case. Examination of the opinion in the *Shenandoah* case will show that the Commissioner there argued that such line of cases had been abrogated by §115(l) and that the court referred to such cases not as authority but merely in the course of reciting what the Tax Court had done. The opinion in the *Shenandoah* case was squarely rested upon the provisions of §115(l). The fact is that the *Shenandoah* case holds on the authority of §115(l) what this Court held in the *Wheeler* case without the benefit of the statute, viz., that realized gains from sales, to the extent recognized under §112, are includible in earnings and profits.

C. The change in the Regulations cannot be justified under lower court decisions rendered prior to the enactment of §115(l).

Petitioner's brief (Point B(1)) refers to certain lower court cases decided under the Revenue Act of 1918 as affording "ample historical justification" for the provision of the Regulation regarding installment sales. Those cases held, on accounting principles, that uncollected profits on installment sales were not includible in invested capital under the excess profits tax imposed by the Revenue Act of 1918. Such cases are not authority, of course, in a case

governed by §115(l), which, so far as sales or other dispositions of property are concerned, has removed the determination of earnings and profits from the domain of accounting and substituted instead the statutory tests of realization and recognition. As stated above, §115(l) was apparently overlooked by the Tax Court in the *Kimbrell case, which relied upon this line of cases.*

Conclusion.

Under the provisions of the statute the taxpayer's gains from its installment sales were realized in full in the year of sale and were recognized in full under the law of the year of sale. Such gains are, therefore, required by the express provisions of §115(l) to be included in the taxpayer's earnings and profits at the dates in question, and accordingly enter into the determination of the taxpayer's invested capital under the provisions of §718(a)(4). The change in the Regulations, which would impose the additional requirement that the gains from installment sales be returned for taxation before inclusion thereof in earnings and profits, is in conflict with §115(l) and cannot be permitted to exclude from earnings and profits gains which are required to be included therein by §115(l).

The judgment of the Circuit Court of Appeals should be affirmed.

Respectfully submitted,

CHARLES C. MACLEAN, JR.,
Counsel for Respondent.
31 Nassau Street,
New York, N. Y.

ARTHUR A. BALLANTINE,
J. ARTHUR PLATT,
RAY I. HARDIN,
Of Counsel.

Appendix

Internal Revenue Code:

Chapter 1—Income Tax

* * * * * *

SUBCHAPTER B—GENERAL PROVISIONS

* * * * * *

Part II—Computation of Net Income

* * * * * *

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

* * * * * *

(f) *Determination of Gain or Loss.*—In the case of a sale or other disposition of property, the gain or loss shall be computed as provided in section 111. * * *

(26 U. S. C. 1940 ed., Sec. 22.)

* * * * * *

Part IV—Accounting Periods and Methods of Accounting

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

(26 U. S. C. 1940 ed., Sec. 41.)

SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. In the case of the death of a taxpayer there shall be included in computing net income for the taxable period in which falls the date of his death, amounts accrued up to the date of his death if not otherwise properly includible in respect of such period or a prior period.

* * * * * *

(26 U. S. C. 1940 ed., Sec. 42, as amended by Section 114 of the Revenue Act of 1941, 55 Stat. 687.)

* * * * * *

SEC. 44. INSTALLMENT BASIS.

(a) *Dealers in Personal Property.*—Under regulations prescribed by the Commissioner with the approval of the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed, bears to the total contract price.

(b) *Sales of Realty and Casual Sales of Personality* [*sic*].—In the case (1) of a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year), for a price exceeding $1,000, or (2) of a sale or other disposition of real property, if in either case the initial payments do not exceed 30 per centum of the selling price (or, in case the sale or other disposition was in a taxable year beginning prior to January 1, 1934, the percentage of the selling price prescribed in the law applicable to such year), the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the basis and in the manner above prescribed in this section. As used in this section the term "initial payments" means the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made.

(26 U. S. C. 1940 ed., Sec. 44.)

SUBCHAPTER C—SUPPLEMENTAL PROVISIONS

* * * * * *

Supplement B—Computation of Net Income
[Supplementary to Subchapter B, Part II]

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount Realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

(c) *Recognition of Gain or Loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this chapter, shall be determined under the provisions of section 112.

(d) *Installment Sales.*—Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received.

(26 U. S. C. 1940 ed., Sec. 111.)

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, de-

termined under section 111, shall be recognized, except as hereinafter provided in this section.

* * * * * *

(26 U. S. C. 1940 ed., Sec. 112.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * * *

(14) *Property Acquired Before March 1, 1913.*—In the case of property acquired before March 1, 1913, if the basis otherwise determined under this subsection, adjusted (for the period prior to March 1, 1913) as provided in subsection (b), is less than the fair market value of the property as of March 1, 1913, then the basis for determining gain shall be such fair market value. In determining the fair market value of stock in a corporation as of March 1, 1913, due regard shall be given to the fair market value of the assets of the corporation as of that date.

* * * * * *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

* * * * * *

(26 U. S. C. 1940 ed., Sec. 113.)

* * * * * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

* * * * * *

(l) *Effect on Earnings and Profits of Gain or Loss and of Receipt of Tax-Free Distributions.*—

The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

(1) for the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. Where in determining the adjusted basis used in computing such realized gain or loss the adjustment to the basis differs from the adjustment proper for the purpose of determining earnings or profits, then the latter adjustment shall be used in determining the increase or decrease above provided. For the purposes of this subsection, a loss with respect to which a deduction is disallowed under section 118, or a corresponding provision of a prior income-tax law, shall not be deemed to be recognized.

• • •

(26 U. S. C. 1940 ed., Sec. 115, as added by §501 of the Second Revenue Act of 1940, 54 Stat. 974, 1004,

and amended by §146(a) of the Revenue Act of 1942, 56 Stat. 798, 841.)

* * * * * * *

Chapter 2—Additional Income Taxes

* * * * * *

SUBCHAPTER E—EXCESS PROFITS TAX [as added by Section 201 of the Second Revenue Act of 1940, *supra*, which provided that the new subchapter may be cited as the "Excess Profits Tax Act of 1940"].

PART I

* * * * * *

SEC. 718. EQUITY INVESTED CAPITAL.

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

* * * * * *

(4) *Earnings and Profits at Beginning of Year.*—The accumulated earnings and profits as of the beginning of such taxable year;

* * * * * *

(26 U. S. C. 1940 ed., Sec. 718.)

SEC. 728. MEANING OF TERMS USED.

The terms used in this subchapter shall have the same meaning as when used in Chapter 1. (26 U. S. C. 1940 ed., Sec. 728.)

Treasury Regulations 111:

SEC. 29.115-3. *Earnings or Profits.*—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February

28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and, while mere bookkeeping entries increasing or decreasing surplus will not be conclusive, the amount of the earnings or profits in any case will be dependent upon the method of accounting properly employed in computing net income. For instance, a corporation keeping its books and filing its income tax returns under sections 41, 42, and 43 on the cash receipts and disbursements basis may not use the accrual basis in determining earnings and profits; a corporation computing income on the installment basis as provided in section 44 shall, with respect to the installment transactions, compute earnings and profits on such basis; and an insurance company subject to taxation under section 204 shall exclude from earnings and profits that portion of any premium which is unearned under the provisions of section 204(b)(5) and which is segregated accordingly in the unearned premium reserve.

Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22(a) or corresponding provisions of prior Revenue Acts. Gains and losses within the purview of section 112 or corresponding provisions of prior Revenue Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section (see section 29.115—12). Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends.

* * * * * * *

SEC. 29.115-12. *Effect on Earnings and Profits of Gain or Loss Realized After February 28, 1913.*—In order to determine the effect on earnings and profits of gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation, section 115 (l) prescribes certain rules for (1) the computation of the total earnings and profits of the corporation, of most frequent application in determining invested capital; and (2) the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, of most frequent application in determining the source of dividend distributions. Such rules are applicable whenever under any provision of chapter 1 or 2 it is necessary to compute either the total earnings and profits of the corporation or the earnings and profits for any period beginning after February 28, 1913. For example, since the earnings and profits accumulated after February 28, 1913, or the earnings and profits of the taxable year, are earnings and profits for a period beginning after February 28, 1913, the determination of either must be in accordance with the rules herein prescribed for the ascertainment of earnings and profits for any period beginning after February 28, 1913. Under (1) such gain or loss is determined by using the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, but disregarding value as of March 1, 1913. Under (2) there is used such adjusted basis for determining gain, giving effect to the value as of March 1, 1913, whenever applicable. • • •

The gain or loss so realized increases or decreases the earnings and profits to, but not beyond, the extent to which such gain or loss was *recognized* in computing net income under the law applicable to the year in which such sale or disposition was made. As used in this subsection, the term "recognized" has reference to that kind of realized gain or loss

which is recognized for income tax purposes by the statute applicable to the year in which the gain or loss was realized, for example, see section 112. A loss (other than a wash sale loss with respect to which a deduction is disallowed under the provisions of section 118 or corresponding provisions of prior revenue laws) may be recognized though not allowed as a deduction (by reason, for example, of the operation of sections 24 (b) and 117 and corresponding provisions of prior revenue laws) but the mere fact that it is not allowed does not prevent decrease in earnings and profits by the amount of such disallowed loss. Wash sale losses, however, disallowed under section 118 and corresponding provisions of prior revenue laws, are deemed nonrecognized losses and do not reduce earnings or profits. The "recognized" gain or loss for the purpose of computing earnings and profits is determined by applying the recognition provisions to the realized gain or loss computed under the provisions of section 115 (l) as distinguished from the realized gain or loss used in computing net income. The application of this paragraph may be illustrated by the following examples:

• • • • • • •

Example (2). On January 2, 1910, the M Corporation acquired nondepreciable property at a cost of $1,000. On March 1, 1913, the fair market value of such property in the hands of the M Corporation was $2,200. On December 31, 1942, the M Corporation transfers such property to the N Corporation in exchange for $1,900 in cash and all the N Corporation stock, which has a fair market value of $1,100. For the purpose of computing the total earnings and profits of the M Corporation the gain on such transaction is $2,000 (the sum of $1,900 in cash and stock worth $1,100 minus $1,000, the adjusted basis for computing gain, determined without regard to March

1, 1913, value), $1,900 of which is recognized under section 112 (c), since this was the amount of money received, although for the purpose of computing net income the gain is only $800 (the sum of $1,900 in cash and stock worth $1,100, minus $2,200, the adjusted basis for computing gain determined by giving effect to March 1, 1913, value). Such earnings and profits will therefore be increased by $1,900. In computing the earnings and profits of the M Corporation for any period beginning after February 28, 1913, however, the gain arising from the transaction, like the taxable gain, is only $800, all of which is recognized under section 112 (c), the money received being in excess of such amount. Such earnings and profits will therefore be increased by only $800 as a result of the transaction. For increase in that part of the earnings and profits consisting of increase in value of property accrued before, but realized on or after, March 1, 1913, see section 29.115-14.

* * * * * * *

Treasury Regulations 112:

SEC. 35.718-2. *Determination of Daily Equity Invested Capital—Accumulated Earnings and Profits.*—(a) *In general.*—The term "accumulated earnings and profits" is not defined in the Internal Revenue Code. See, however, section 115 and the regulations prescribed thereunder as to the effect of certain transactions on earnings and profits, and section 35.718-5 as to the effect of the declaration and distribution of dividends. In general, the concept of "accumulated earnings and profits" for the purpose of the excess profits tax is the same as for the purpose of the income tax. * * *

* * * * * * *

IN THE

Supreme Court of the United States

OCTOBER TERM 1947

No. 384

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

SOUTH TEXAS LUMBER COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

RESPONDENT'S MOTION FOR LEAVE TO FILE PETITION FOR REHEARING OUT OF TIME AND PETITION FOR REHEARING.

CHARLES C. MacLEAN, JR.,
Counsel for Respondent,
31 Nassau Street,
New York, N. Y.

IN THE

Supreme Court of the United States

OCTOBER TERM 1947

No. 384

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

SOUTH TEXAS LUMBER COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

MOTION FOR LEAVE TO FILE PETITION FOR REHEARING OUT OF TIME.

To the Honorable the Chief Justice of the United States and the Associate Justices of the Supreme Court of the United States:

Comes now the respondent in the above-entitled cause and respectfully moves for leave to file at this time the annexed petition for rehearing.

The ground for this motion is that the recent amendment to Rule XXXIII of the Rules of this Court which decreased the time for filing petitions for rehearing as of right from twenty-five days after entry of judgment to fifteen days after entry of judgment or decision was not reflected in the latest supplement to the edition of the Rules of this Court which was consulted for purposes of deter-

mining the time within which to file said petition and that the failure to file a petition within the time specified by the Rules was the result of failure to note such change in the Rules of this Court.

The discretionary jurisdiction of this Court to grant leave to file such petition for rehearing is invoked under said Rule XXXIII which contemplates that the time for filing such a petition may be enlarged. The Court has previously exercised such jurisdiction (*Douglas* v. *Willcuts*, 293 U. S. 626, 295 U. S. 722, 296 U. S. 1). Under Rule XXXIII the Court has the power vested in both trial and appellate courts, to reconsider its own decisions within the same Term (*Bronson* v. *Schulten*, 104 U. S. 410, 415; *United States* v. *Benz*, 282 U. S. 304, 306, 307; *Wayne Gas Co.* v. *Owens Co.*, 300 U. S. 131, 136; *Hazel-Atlas Co.* v. *Hartford-Empire Co.*, 322 U. S. 238, 244). This case is not governed by *R. Simpson & Co.* v. *Commissioner*, 321 U. S. 225 since certiorari was granted herein and the mandate herein has not yet been issued.

The Court granted certiorari herein on petition by the Commissioner on the ground that "the questions thereby raised are of importance in tax administration". It is submitted that, for the same reason, the Court should exercise its discretion to permit the filing of the petition for rehearing in order that the questions may be given full consideration.

Respectfully submitted,

CHARLES C. MACLEAN, JR.,
Counsel for Respondent,
31 Nassau Street,
New York, N. Y.

IN THE

Supreme Court of the United States

OCTOBER TERM 1947

No. 384

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

SOUTH TEXAS LUMBER COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

RESPONDENT'S PETITION FOR REHEARING.

To the Honorable the Chief Justice of the United States and the Associate Justices of the Supreme Court of the United States:

Comes now the respondent in the above entitled cause and presents this its petition for a rehearing, and in support thereof respectfully shows:

The question presented to this Court was whether, under §115(l) I. R. C., the full amount of the respondent's profits on installment sales made prior to the taxable years here involved was to be included in the respondent's earnings and profits and therefore in its equity invested capital for

excess profits tax purposes. This Court, reversing the decision of the Circuit Court of Appeals for the Fifth Circuit, held that the part of such profits on which no tax had been paid prior to such taxable years was not to be included.

In so deciding, this Court held: first, that the regulation relied on by the Commissioner* was reasonable and, second, that the regulation was not in conflict with the provisions of §115(l) I. R. C.

The Court's construction and application of §115(l) I. R. C. in its decision herein leads to the result, which this Court could not have contemplated, that the portion of the respondent's profits from installment sales reported for taxation in a year subsequent to the year of sale can *never* be included in the respondent's earnings and profits either for excess profits tax purposes or dividend purposes. The Court was led into this misconstruction of the statute by a false impression as to the nature of the installment method of reporting income created by the Commissioner.

I. The decision of this Court disregards the statutory provision "under the law applicable to the year in which such sale or disposition was made" contained in Section 115(l) and leads to results plainly contrary to Congressional intent.

As the Commissioner has conceded, the following provision of §115(l) I. R. C. is applicable to this case:

> "Gain or loss so realized [from the sale or other disposition of property] shall increase or decrease the

* Reg. 111, §29.115-3 which provides: "* * * a corporation computing income on the installment basis as provided in section 44 shall, with respect to the installment transactions, compute earnings and profits on such basis * * *."

> earnings and profits to, *but not beyond*, the extent to which such a realized gain or loss was recognized in computing net income *under the law applicable to the year in which such sale or disposition was made.*" (Italics added.)

The Court held that there is no conflict between the regulation in question and this statutory provision (requiring the inclusion in earnings and profits of all gain satisfying the statutory tests) because the portion of the profit from an installment sale which is properly reportable for taxation in a year subsequent to the year of sale is *not*

> "recognized in computing net income under the law applicable to the year in which such sale or disposition was made"

within the meaning of the statute. In order to reach this conclusion, the Court

(a) construed the "recognition" requirement of §115(l) above quoted as referring to §44 and §111(d) (relating to installment sales) of the revenue acts applicable to the years of sale, and

(b) construed §44 and §111(d) (as they appeared in the Revenue Act of 1936, the Revenue Act of 1938 and the Internal Revenue Code for 1941) as providing for the *non-recognition* of the part of the gain from an installment sale which is properly subjected to tax in a year subsequent to the year in which the sale was made.

It is respectfully submitted that the construction so placed by this Court upon the statutes involved disregards the full effect of the phrase "under the law applicable to the year in which such sale or disposition was made" appearing in §115(l) and leads to results which Congress

could never have intended. The nature of those results may be aptly illustrated by the facts of the present case.

Most of the installment sales here involved were made in 1937 (R. 27). The law applicable to the year of such sales was the Revenue Act of 1936. This Court in its decision held that part of the profits from such sales which was subject to tax in years subsequent to 1937 was not "recognized in computing net income under the law applicable to the year in which such sale or disposition was made", *i.e.*, under the Revenue Act of 1936. In so doing, as appears from the opinion, the Court naturally assumed that all of the gain would *eventually* meet the statutory test and enter earnings and profits. However, that cannot be the result under the statute as construed by the Court.

Under the provisions of §115(l), profits from sales can enter earnings and profits at any time *only* if they are "recognized in computing net income *under the law applicable to the year in which such sale or disposition was made.*" By reason of the provisions of §63 of the Revenue Act of 1938, *none of the income tax provisions of the Revenue Act of 1936 applies to any taxable year of the respondent after 1937.** From this fact and the decision of this Court it would follow that the part of the profits from installment sales made in 1937 which was in later years included in the respondent's taxable income under the *Revenue Act of 1938*, and revenue laws applicable to *other years subsequent to the year of sale*, was not recognized under the *Revenue Act of 1936*, which was "the law applicable to the year in

---

* Section 63 of the Revenue Act of 1938 provides:

"Sec. 63. *Taxes in Lieu of Taxes Under 1936 Act.*—The taxes imposed by this title and Title IA shall be in lieu of the taxes imposed by Titles I and IA of the Revenue Act of 1936, as amended."

which such sale or disposition was made." The necessary consequence of this Court's holding is that such profits could *never* be included in the respondent's earnings and profits, even after such profits had been subjected to tax.

Recognition of such profits under the law applicable to a year *subsequent* to the year of sale would not satisfy the test of §115(l), because such subsequent year is not "the year in which such sale or disposition was made."

The consequence of this Court's holding that such profits were not recognized under the law of the year of sale, as required by §115(l) for inclusion in earnings and profits, would be (a) that the respondent would *never* be able to include such profits, even when tax-paid, in its accumulated earnings and profits for purposes of its invested capital credit, and (b) that the respondent could *at any time* distribute such profits to its stockholders free of dividend tax. The same considerations apply to profits from installment sales made by the respondent in years after 1937.

These results certainly could not have been intended by Congress. Yet they are inevitable under the construction which this Court has read into the applicable statutory provisions—a construction which is neither required nor suggested by their language.

During the course of this proceeding the Commissioner has, from time to time, urged various constructions of the phrase "recognized in computing net income" as it is used in §115(l). But the above-mentioned results would follow from any holding that any part of the profit from an installment sale was not "recognized in computing net income" under the law applicable to the year of sale, regardless of the meaning attached to the phrase "recognized in computing net income." If, as this Court holds, the part of the profit from an installment sale which is properly taxed

in a year subsequent to the year of sale is not "recognized in computing net income" (whatever meaning is attached to that phrase) "under the law applicable to the year in which such sale or disposition was made," such part of the profit will never meet the statutory test of §115(l) for inclusion in earnings and profits and therefore can never enter earnings and profits.

It is submitted, therefore, that in construing the statutes here involved this Court overlooked the significance of the phrase "under the law applicable to the year in which such sale or disposition was made," with the result that the decision of the Court deprives the statutes of sensible meaning and gives them a meaning which could never have been intended by Congress. The statutes can be given a sensible meaning only by construing §115(l) as referring to the recognition provisions of §112 in effect in the year of sale, under which, in each case, the full amount of the gain from an installment sale was recognized.

II. The decision of this Court was based upon an erroneous conception of the nature of the installment method of reporting income.

Both in holding the regulation relied on by the Commissioner to be reasonable and in construing §115(l), the Court was misled by the Commissioner's claim that the installment method of reporting income was a separate and independent system of accounting. By this claim, which is irrelevant otherwise, the Commissioner created the false impression that the installment method has the symmetry to be expected of a system of accounting. Actually, its demonstrable lack of symmetry constitutes a strong reason in support of the view that the installment method does not constitute a separate and independent method of accounting.

1. In holding the regulation relied on by the Commissioner to be reasonable, this Court mistakenly relied on the general principle that both income and deductions must be computed under the same method of accounting. *That principle does not apply where income is reported on the installment method because deductions are never taken on the installment basis.* This is expressly provided in the regulations relating to installment sales (Reg. 111, §29.44-1) as follows:

> "Deductible items are *not* to be allocated to the years in which the profits from the sales of a particular year are to be returned as income, *but must be deducted for the taxable year in which the items are 'paid or incurred' and 'paid or accrued,'* as provided by sections 43 and 48." (Italics added.)

The same provision (with slight differences in wording) has been in the regulations ever since Reg. 69, Art. 42 was adopted under the Revenue Act of 1926, the first Revenue Act to permit the installment method.

One of the reasons why the installment method was held in *B. B. Todd, Inc.*, 1 B. T. A. 762, 764 (1925) before the adoption of §44 to be a method of accounting which did not clearly reflect income was that under the statute all deductions (including those relating to the installment sales) were required to be reported on either the accrual basis or the cash basis, according to the taxpayer's method of reporting other transactions. Congress subsequently, by specific legislation, authorized the use of the installment method of reporting *income*, notwithstanding the fact that *deductions* were still required to be reported on either the cash or the accrual method.

Under those circumstances it would seem proper to regard §44 as merely deferring taxation of installment gains

until cash to pay the tax is in hand. If, however, §44 is taken instead to provide a separate and independent "system of accounting," such a system is, as this Court said, a "hybrid method" of accounting, the hybrid nature of which is due to "the Commissioner's regulations and to long-standing tax practices recognized by statutes and judicial opinions." In relying on the general principle that income and deductions must be reported on the same basis, the Court was clearly not aware of the hybrid nature of the installment method itself.

It is submitted, therefore, that this Court's holding that the regulation relied on was reasonable was based on a misapprehension as to the nature of the installment method of reporting income.

2. This misapprehension of the essentially hybrid nature of the installment method of reporting income was also behind the Court's holding that the regulation relied on by the Commissioner was not in conflict with §115(l).

The Committee Reports on §115(l) (quoted in the Court's opinion) refer only to §112 I. R. C. in explaining the meaning of the term "recognized" as used in §115(l). In spite of that fact this Court declined to construe §115(l) as referring to §112 I. R. C. and the corresponding recognition sections of prior revenue acts. This Court was led to reject the obvious construction of the term "recognized" in §115(l) as referring to §112 on the theory* that Con-

---

* The Court said:

> "In the first place, neither §115(l) nor any other purports to alter the Commission's power to promulgate reasonable regulations which require taxpayers who adopt the installment basis of accounting to use an accounting method that reflects true income. The hybrid method here urged would not accomplish that result."

gress could not have intended to authorize a "hybrid method" of accounting by permitting (under §115(l) or any other section) deductions to be taken on the accrual basis where income is reported on the installment basis. Such doubts as to the Congressional intent vanish, however, when it is understood that Congress, after the decision in the *Todd* case, *supra*, specifically authorized the installment method of reporting income notwithstanding the fact that, considered as a system of accounting, such method is clearly a "hybrid method" in which income is reported on one basis and deductions are reported on another.

WHEREFORE, respondent respectfully petitions for a rehearing and prays that the decision of the United States Circuit Court of Appeals for the Fifth Circuit be affirmed.

Respectfully submitted,

CHARLES C. MACLEAN, JR.
Counsel for Respondent,
31 Nassau Street,
New York, N. Y.

Certificate of Counsel.

I, CHARLES C. MACLEAN, JR., counsel for the above-named respondent, do hereby certify that the foregoing petition for a rehearing is presented in good faith and not for delay.

CHARLES C. MACLEAN, JR.
Counsel for Respondent.

SUPREME COURT OF THE UNITED STATES

No. 384.—October Term, 1947.

Commissioner of Internal Revenue, Petitioner, *v.* South Texas Lumber Company.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

[March 29, 1948.]

Mr. Justice Black delivered the opinion of the Court.

This case raises a question as to respondent's liability for the taxable year 1943 under the Excess Profits Tax of 1940 as amended. 54 Stat. 975, 26 U. S. C. § 710, *et seq.* The law was passed to tax abnormally high profits due to large governmental expenditures about to be made from appropriations for national defense.[1] The excess profits tax was a graduated surtax upon a portion of corporate income, and was imposed in addition to the regular income tax. It applied to all corporate profits and gains over and above what Congress deemed to be a fair and normal return for the corporate business taxed.

Under the controlling 1943 law the amount of income subject to this excess profits tax is computed by subtracting from the net income subject to regular income tax the amount of earnings Congress deemed to be a taxpayer's normal and fair return.[2] This deductible amount, called the excess profits credit, was to be computed in one of two ways, whichever resulted in the lesser tax. § 712. The first, not used here, permits a deduction of an amount equal to the company's average net income for the taxable years 1936 to 1939 inclusive. § 713. The

[1] H. R. No. 2894, 76th Cong., 3d Sess., 1-2.

[2] Other adjustments not here material are provided, but the chief deduction or "adjustment" is the one noted above.

second, used here, permits a deduction of an amount equal to 8 per centum of the taxpayer's invested capital for the taxable year.[3] § 714. An includable element of the "invested capital" is the "accumulated earnings and profits as of the beginning of such taxable year." It thus appears that by this method Congress intended, with minor exceptions not here relevant, to impose the excess profits tax on all annual net income in excess of 8% of a corporation's working capital, including its accumulated profits. The controversy here is over the taxpayer's claim that in computing its 1943 tax the statute allows it to include in this 8% deduction its "accumulated profits" from certain installment sales, which profits the taxpayer, in accordance with an option conferred upon him, had elected not to report as a part of its taxable income in prior years.

Beginning in 1937 and extending over a four-year period, respondent sold parcels of real estate, gave deeds, and took installment notes, which were secured by mortgages and vendors liens. It kept its books generally on a calendar year accrual basis of accounting, a basis under which all obligations of a company applicable to a year are listed as expenditures, whether paid that year or not, and all obligations to it incurred by others applicable to the year are set up as income on the same basis. Under 26 U. S. C. § 41 an income taxpayer may report income and expenditures either on an accrual basis, or on a cash basis—under which latter method annual net income is measured by the difference between actual cash received and paid out within the taxable year. In any event, the basis used must, in the language of § 41, "clearly reflect the income."

[3] The straight 8% figure of 1940 was modified in several respects not here material in 1941 and subsequent years. 55 Stat. 699; 56 Stat. 911; 58 Stat. 55.

Respondent did not report the value of its land installment notes as income on the accrual basis as it could have done under § 41. Instead, from 1937 up to and including 1943, it has consistently reported its annual income from the installment sales on a third, or "installment" basis, expressly authorized for certain types of installment sales by 26 U. S. C. § 44. That section permits a taxpayer to return as taxable income for a given year only "that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed, bears to the total contract price." Thus respondent's installment income has actually been reported for taxes all along substantially on a modified cash receipts basis, and the taxpayer's net income, which is subjected both to the normal income tax and to the excess profits tax, has not in any of these years reflected the unpaid balances on the installment notes, or any part of them. On the contrary, these balances were listed on respondent's tax returns during these years as "Unrealized Profit Installment Sales."

On its 1943 excess profits tax return respondent nevertheless reported as "accumulated earnings and profits" the amount of "Unrealized Profit Installment Sales" shown on its books at the end of 1942,[4] and included this amount in "invested capital." It thus sought to deduct 8% of its theretofore designated "unrealized profit" in computing its excess profits tax. The Commissioner redetermined the tax for 1943 after eliminating this item from "invested capital." The Tax Court sustained the Commissioner's redetermination, 7 T. C. 669, relying on its opinion in *Kimbrell's Home Furnishings Inc.*, 7 T. C.

[4] In its 1943 return respondent also reported the amount of such unrealized profits shown on its books as of the end of the two preceding years for purposes of calculating the excess profits credit carryover authorized by § 710 (c).

339.[5] The Circuit Court of Appeals, with one justice dissenting, reversed on the authority of its decision in *Commissioner* v. *Shenandoah Co.*, 138 F. 2d 792. The Government's petition for certiorari alleged that the result reached by the Circuit Court of Appeals was counter to the Commissioner's regulations and to long-standing tax practices recognized by statutes and judicial opinions, under which practices a taxpayer normally cannot report taxable income on one accounting basis and adjustments of that income on another. The questions thereby raised are of importance in tax administration and we granted certiorari to consider them.

A Treasury regulation, set out in part below,[6] applicable to both the normal income tax and the excess profits tax,[7] specifically provides that "a corporation computing income on the installment basis as provided in section 44

---

[5] The *Kimbrell* case was subsequently reversed but not on the contention here urged. 159 F. 2d 608.

[6] Section 29.115–3 of Regulations 111: *"Earnings or Profits.*—In determining the amount of earnings or profits (whether of the taxable year, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and, while mere bookkeeping entries increasing or decreasing surplus will not be conclusive, the amount of the earnings or profits in any case will be dependent upon the method of accounting properly employed in computing net income. For instance, a corporation keeping its books and filing its income tax return under sections 41, 42, and 43 on the cash receipts and disbursements basis may not use the accrual basis in determining earnings and profits; a corporation computing income on the installment basis as provided in section 44 shall, with respect to the installment transactions, compute earnings and profits on such basis; . . . ."

[7] The meaning of all terms used in the subchapter dealing with the income tax was expressly made applicable to terms used in the excess profits subchapter. § 728. Treasury Regulations 112 provided: ". . . In general, the concept of 'accumulated earnings and profits' for the purpose of the excess profits tax is the same as for the purpose of the income tax." § 35.718–2. See also H. R. No. 2894, 76th Cong., 3d Sess., 41.

shall, with respect to the installment transactions, compute earnings and profits on such basis."[8] Since respondent computed its taxable income from installment sales on the installment or modified cash receipts basis, but computed its earnings and profits from these same sales on another basis, the accrual, it contends that the regulation is invalid because inconsistent with the governing code provisions.[9] Validity of the regulation is therefore the crucial question.

This Court has many times declared that Treasury regulations must be sustained unless unreasonable and plainly inconsistent with the revenue statutes and that they constitute contemporaneous constructions by those charged with administration of these statutes which should not be overruled except for weighty reasons. See, *e. g.*, *Fawcus Machine Co.* v. *United States*, 282 U. S. 375, 378.

This regulation is in harmony with the long-established congressional policy that a taxpayer generally cannot compute income taxes by reporting annual income on a cash basis and deductions on an accrual basis. Such a practice has been uniformly held inadmissible because it results in a distorted picture which makes a tax return fail truly to reflect net income. This has been the construction given income, estate, and previous excess profits tax laws by administrative officials, the Board of Tax Appeals, and the courts.[9]

---

[8] This part of the regulation was added as an amendment to Reg. 103, § 19.115–3, now § 29.115–3 of Reg. 111, after adoption of the 1940 Excess Profits Tax Law. T. D. 5059, July 8, 1941.

[9] G. C. M. 2951, VII–I Cum. Bull. 160 (1928); I. T. 3253, 1939–1 Cum. Bull. 178; *Consolidated Asphalt Co.*, 1 B. T. A. 79, 82; *Henry Reubel Executor*, 1 B. T. A. 676, 678–680; *B. B. Todd, Inc.*, 1 B. T. A. 762, 766; *Bank of Hartsville*, 1 B. T. A. 920, 921; *Atlantic Coast Line R. Co.*, 2 B. T. A. 892, 894–895; *United States* v. *Anderson*, 269 U. S. 422, 440; *Jacob Bros.* v. *Comm'r*, 50 F. 2d 394, 396; *Jenkins* v. *Bitgood*, 22 F. Supp. 16, 17–18, aff'd., 101 F. 2d 17.

The regulation's reasonableness and consistency with the statutes which impose the excess profits tax on incomes is also supported by prior legislative and administrative history. The present "invested capital" deduction is patterned after a similar provision in § 326 (a) of the Revenue Act of 1918, 40 Stat. 1057, 1088, 1092. That section imposed a "War Profits and Excess Profits Tax." Invested capital there included "paid in or earned surplus and undivided profits." Under that law the administration, the Board of Tax Appeals, and the courts have uniformly held that a taxpayer, having elected to adopt the installment basis of accounting, could not thereafter distort his true excess profits tax income by including uncollected installment obligations in his "invested capital" deduction base.[10] A taxpayer, having chosen to report his taxable income from installment sales on the installment cash receipts plan, thereby spreading its gross earnings and profits from such sales over a number of years and avoiding high tax rates, was not permitted to obtain a further reduction by shifting to an accrual plan and treating uncollected balances on these installment sales as though they had actually been received in the year of the sale.

The history of the congressional adoption of the optional installment basis also supports the power of the Commissioner to adopt the regulation here involved. Prior to 1926 the right of a taxpayer to report on the

[10] *Schmoller & Mueller Piano Co.* v. *United States*, 67 C. Cls. 428; *John M. Brant Co.* v. *United States*, 40 F. 2d 126; *Standard Computing Scale Co.* v. *United States*, 52 F. 2d 1018; *Jacob Bros.* v. *Comm'r*, 50 F. 2d 394; *Tull & Gibbs* v. *United States*, 48 F. 2d 148; *Blum's Inc.* v. *Comm'r*, 7 B. T. A. 737, 771; *New England Furniture & Carpet Co.* v. *Comm'r*, 9 B. T. A. 334; *Green Furniture Co.* v. *Comm'r*, 14 B. T. A. 508; *S. Davidson & Bros.* v. *Comm'r*, 21 B. T. A. 638, 644; *Federal St. & Pleasant Valley Passenger R. Co.* v. *Comm'r*, 24 B. T. A. 262, 266.

installment plan rested only on Treasury regulations.[11] In 1925, the Board of Tax Appeals held these regulations were without statutory support.[12] Congress promptly, in § 212 (d) of the 1926 Revenue Act, adopted the present statutory authority for an elective installment basis for reporting income, the Senate committee report on the measure designating it as a "third basis, the installment basis."[13] This new statutory provision was strikingly similar to the Treasury regulations previously held unauthorized by the Board of Tax Appeals. That the Commissioner was particularly intended by Congress to have broad rule-making power under the regulation was manifested by the first words in the new installment basis section which only permitted taxpayers to take advantage of it "Under regulations prescribed by the Commissioner with the approval of the Secretary . . . ." The clause is still contained in § 44 of the code. This gives added reasons why interpretations of the Act and regulations under it should not be overruled by the courts unless clearly contrary to the will of Congress. See *Burnet* v. *S. & L. Bldg. Corp.*, 288 U. S. 406, 415.

The installment basis of reporting was enacted, as shown by its history, to relieve taxpayers who adopted it from having to pay an income tax in the year of sale based on the full amount of anticipated profits when in fact they had received in cash only a small portion of the sales price. Another reason was the difficult and time-consuming effort of appraising the uncertain market

---

[11] Article 117 of Regulations 33 (Revised) promulgated Jan. 2, 1918, and Article 42 of Regulations 45, promulgated April 17, 1919.

[12] *B. B. Todd Inc.*, 1 B. T. A. 762; *H. B. Graves Co.*, 1 B. T. A. 859; *Hoover Bond Co.*, 1 B. T. A. 929; *Six Hundred and Fifty West End Avenue Co.*, 2 B. T. A. 958.

[13] S. Rep. No. 52, 69th Cong., 1st Sess., 19, the Senate Finance Committee's report on Revenue Act of 1926, 44 Stat. 9, 23.

value of installment obligations.[14] There is no indication in any of the congressional history, however, that by passage of this law Congress contemplated that those taxpayers who elected to adopt this accounting method for their own advantage could by this means obtain a further tax advantage denied all other taxpayers, whereby they could, as to the same taxable transaction, report in part on a cash receipts basis and in part on an accrual basis.

We find nothing unreasonable in the regulations here. See *Commissioner* v. *Wheeler*, 324 U. S. 542.

It is argued that notwithstanding what has been said, Congress by enacting § 501 of the 1940 Second Revenue Act, 54 Stat. 974, 1004, 26 U. S. C. § 115 (1), had provided a definition of "earnings and profits" which includes these unpaid installment obligations and that the regulation here conflicts with § 115 (1),[15] which is applicable alike to both the income and the excess profits taxes. There are at least two reasons why we cannot accept this argument. In the first place, neither § 115 (1) nor any other purports to alter the Commission's power to promulgate reasonable regulations which require taxpayers who adopt the installment basis of accounting to use an accounting method that reflects true income. The hybrid method here urged would not accomplish that result.

---

[14] S. Rep. No. 52, 69th Cong., 1st Sess. 19; *Willcuts* v. *Gradwohl*, 58 F. 2d 587, 589–590.

[15] Section 115 (1) provides: "The gain or loss realized from the sale or other disposition of property by a corporation— . . .

"(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

"Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made."

In the second place, we cannot agree with the respondent's interpretation of § 115 (1). He argues that "earnings and profits" derived from a sale of property are defined in § 115 (1) considered in the light of §§ 111, 112, and 113; that these sections together define such earnings and profits as all gain "realized" in the year of sale and "recognized" under the law applicable to the year of sale; that all the anticipated profits from these installment sales were "realized" when the sales were made because the installment obligations of the purchasers were received by respondent in the year of sale and they must be assumed to have been worth their face value; that they were "recognized" as taxable by § 111 (c), the law applicable to the year of sale; and that consequently, the Commissioner was compelled to accept these lawfully "realized" and "recognized" accumulated profits as "invested capital" for excess profits tax purposes, even though not previously reported as taxable income for either income tax or excess profits tax purposes. Finally respondent contends that § 44 merely conferred upon it a privilege to defer payment of income tax on its tax-"recognized" profits realized from installment sales until the unpaid installment obligations were collected.

The congressional reports on § 115 (1) do not provide support for the idea that gains not included in taxable income under the taxpayer's method of accounting may nevertheless be considered "realized" and "recognized" for computing tax adjustments or deductions so long as they might have entered into such computations under a different method of accounting.[16] Furthermore, neither

[16] The Conference Committee report on the Second Revenue Act of 1940, 54 Stat. 974, said with reference to § 115 (1): "The provisions in the House and Senate bills, that gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent *recognized* in computing net income under the law applicable

§§ 111, 112, nor 113, require a "recognition" of the full face value of installment paper. It is true that § 111 (b) does provide that gain or loss "realized" from the sale of property shall be measured by the "sum of any money received plus the fair market value of the property (other than money) received" and § 111 (c) provides that the extent of gain or loss shall be "recognized" as determined "under the provisions of section 112." But § 111 (d) provides that nothing in § 111 "shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received." This means that where a taxpayer has validly reported its income from installment sales on the installment basis provided by § 44, that section, not §§ 111, 112, and 113 prescribes the extent to which receipts from such sales are "recognized" as taxable and the year in which such receipts are "recognized" in computing taxable income. Section 44 provides for the return as income "in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed, bears to the total contract price." Unlike § 111, § 44 does not recognize as subject to income tax liability the "market value" of deferred installment obligations. They may never be recognized by a taxpayer on the installment basis for tax purposes under § 44 or any other section, for they may never be paid, or may be paid only in part. The anticipated profits from these deferred obligations are

---

to the year in which such sale or disposition was made, are retained. As used in this subsection the term 'recognized' relates to a realized gain or loss which is recognized pursuant to the provisions of law, for example, see section 112 of the Internal Revenue Code. It does not relate to losses disallowed or not taken into account." Conf. Rep. No. 3002, 76th Cong., 3d Sess., 60.

recognized and taxable under § 44 only if the obligations are paid and when they are paid, unless they are sold or transferred before payment. Thus whatever meaning is given to the words "realized" and "recognized" the regulation here considered is not in conflict with §§ 115 (1), 111, 112, and 113.

The regulation is valid. The respondent can include in its equity invested capital only that portion of its profits from installment payments which it has actually received and on which it has already paid income taxes in the years of receipt.

Reversed.

MR. JUSTICE DOUGLAS and MR. JUSTICE BURTON dissent.